

REVERSE VESTING ORDERS – A POWERFUL TOOL FOR MAXIMIZING RECOVERY IN COMPLEX INSOLVENCIES

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Reverse vesting orders (or “RVOs”) allow the realization of value from assets of a debtor company in circumstances where a traditional transaction model is not effective, preserving the value of permits, tax losses and other assets which cannot be transferred to a purchaser. Two recent decisions demonstrate the willingness of courts to embrace creative solutions, where appropriate, to realize value for stakeholders.

What is a Reverse Vesting Order?

A traditional vesting order transfers assets out of the insolvent company to the purchaser, leaving behind any unwanted assets and liabilities. In contrast, a reverse vesting order transfers undesirable assets and liabilities from the insolvent company to another company, typically incorporated specifically for the purpose. This leaves the debtor company holding only those assets and liabilities that the purchaser wishes to acquire, allowing the shares of the debtor company to be sold, preserving valuable permits, contracts, tax losses, or as discussed below, statutory authority, which cannot be transferred.

RVOs have been granted in Canadian proceedings as early as 2000^[1]. More recently, courts have approved RVOs in cases such as *Stornaway Diamond Corporation*^[2] and *Comark Holdings Inc.*^[3] However, there was no opposition to the use of RVOs in those cases, and the courts gave brief, if any, reasons for their decisions^[4].

In two recent decisions, *Nemaska Lithium*^[5] and *Quest University*^[6], the appellate courts of Quebec and British Columbia have upheld decisions of judges in *Companies’ Creditors Arrangement Act* (“**CCAA**”) proceedings granting RVOs in the face of opposition from stakeholders. The comprehensive reasons of the CCAA judges provide guidance for similar applications, shedding light on when RVOs may be an appropriate tool to maximize the benefit for all stakeholders.

Recent Developments

Nemaska Lithium

The Nemaska entities were involved in a lithium-mining project in Quebec. The RVO was sought to allow the purchaser to carry on operations by maintaining existing permits, licenses, authorizations and fiscal attributes.

Notably, the RVO would result in the Nemaska entities emerging from CCAA protection outside of a plan of compromise or arrangement.

Justice Gouin approved the RVO over the objections of two parties who argued, among other things, that a CCAA judge lacked the authority to grant a vesting order for anything other than a sale or disposition of assets and that a company cannot emerge from CCAA protection outside a compromise or arrangement.

The appeal was brought by the same parties who raised the objections to the RVO before the CCAA judge. The Court of Appeal dismissed the application for leave to appeal stating that the court was not convinced that the appellants' arguments were anything but a "bargaining tool"^[7]. In particular, the Court of Appeal noted that one of the objecting parties, Cantore, was the only creditor objecting to the RVO approval and held only 4% of the total value of unsecured creditors' claims as determined by the Monitor. The Court questioned whose interest was being served by the proposed appeal and what impact Cantore's vote would have if the RVO transaction was made subject to prior creditor approval.

The Court of Appeal was also concerned that granting leave to appeal could compromise the RVO transaction and result in a bankruptcy of the Nemaska entities, which would be, as the CCAA judge put it, "catastrophic" for the broader stakeholder group.

The two objecting parties applied to the Supreme Court of Canada for leave to appeal the Court of Appeal's decision. However, on April 29, 2021, the Supreme Court of Canada dismissed their applications.

Quest University

Quest University Canada ("**Quest**") is a not-for-profit post-secondary education institution located in Squamish, British Columbia, empowered by statute to grant degrees. Quest obtained protection under the CCAA and following a sale process, entered into an agreement with a purchaser to restructure and continue the university's operations.

Quest initially sought to have the transaction implemented by way of a traditional approval and vesting order, which was conditional on (among other things) the approval of a plan of compromise and arrangement by the university's creditors. However, when it became apparent that any plan would fail – given the objections of a major creditor, Southern Star Developments Ltd. ("**Southern Star**") – Quest sought an RVO instead.

Under the RVO, certain assets, contracts, claims and liabilities of Quest would be transferred to a wholly-owned subsidiary of the university, Quest Guardian Properties Ltd. ("**Guardian**"). Various assets needed for the ongoing operations of the university and, most significantly, Quest's ability to grant degrees, remained with Quest.

Southern Star and another creditor, Dana Hospitality LP (“**Dana**”), opposed the granting of the RVO. The primary objection to the RVO was that it would mean that Quest would be released from pre-filing obligations, including those to Southern Star, without the creditors having an opportunity to vote on a plan. Notwithstanding the creditors' opposition, Madam Justice Fitzpatrick granted the RVO.

Justice Fitzpatrick confirmed that the CCAA gives the court broad discretion to “grant relief that represents an innovative solution to any challenges in a proceeding.”^[8] However, the CCAA judge noted that “the ability of a CCAA court to be innovative and creative is not boundless; as always, the court must exercise its discretion with a view to the statutory objectives and purposes of the CCAA”^[9].

Justice Fitzpatrick also noted that although the RVO did not contemplate a plan by Quest, Guardian would be submitting its own plan to unsecured creditors, including Southern Star and Dana, at which time they could vote their self-interest. The judge observed that the proposed RVO transaction was the only transaction that had emerged to resolve the financial affairs of Quest, and that without the RVO structure that transaction was in jeopardy. Justice Fitzpatrick commented that both Southern Star and Dana potentially held “the sword of Damocles over the head of the significant broad stakeholder group” who stood to benefit from the transaction, and that the objecting creditors had nothing to lose in “this dangerous game of chicken”^[10]. The CCAA judge noted, however, that an RVO structure should not be used “to simply rid a debtor of a recalcitrant creditor who may seek to exert leverage through its vote on a plan”.^[11] Justice Fitzpatrick exercised her discretion to approve the RVO structure, based on the unique and exceptional circumstances of the case.

Southern Star sought leave to appeal that decision on several grounds, including that the CCAA judge erred in granting a vesting order that deprived Southern Star of the right to “participate in a plan of arrangement process that effected a fair and equitable compromise of its claims”.^[12]

The British Columbia Court of Appeal (“**BCCA**”) reviewed the CCAA judge's reasoning in granting the RVO. The appellate court noted that Justice Fitzpatrick relied on the broad discretion granted to judges under the CCAA, while also being aware that such discretion must be exercised in line with the objectives and purposes of the CCAA. The BCCA also noted that, while there was limited authority for granting an RVO in a contested proceeding, leave to appeal was refused in *Nemaska Lithium*, the only other case in which it had occurred, and one with similar facts.

The BCCA declined to grant leave to appeal, commenting that, as in *Nemaska Lithium*, granting leave would likely doom the transaction and harm Quest's stakeholders.

General Principles

The CCAA judges in both *Nemaska Lithium* and *Quest University* emphasized the broad discretion available to

the court under sections 11 and 36 of the CCAA to facilitate creative solutions to challenges that arise in CCAA proceedings. However, both CCAA judges recognized that courts must exercise their discretion with a view to the statutory purposes and objectives of the CCAA. Both justices looked to the principles guiding the exercise of jurisdiction under the CCAA as set out by the Supreme Court of Canada in *9354-9186 Quebec inc. c. Callidus Corp.*^[13], including the remedial objectives of the CCAA and good faith and due diligence on the part of the debtor.

In each case, the CCAA judge utilized the *Soundair*^[14] criteria for approval of a sale, as well as those in section 36 of the CCAA, to determine whether to approve the transactions, indicating that there is no specific test that must be satisfied for an RVO to be granted. Relevant considerations include: (i) whether the party conducting the sale made sufficient efforts to obtain the best price and did not act improvidently; (ii) the interests of all parties; (iii) the efficacy and integrity of the process by which offers were obtained; and, (iv) whether there has been any unfairness in the sales process.

Justice Gouin and Justice Fitzpatrick both questioned the extent to which the objections to the RVO (or, in Southern Star's case, the potential veto of any plan) were for strategic purposes, part of a "game of chicken"^[15] which risked significant harm to the other stakeholders if the transaction was not approved.

In each case, the court focussed on the fact that the transaction, implemented by way of the RVO, was the only option before the court, without which, the proposed transaction – and resulting value for stakeholders – would be in jeopardy.

Conclusion

Nemaska Lithium and Quest University demonstrate that, in appropriate circumstances, CCAA courts are willing to approve creative solutions that preserve value for stakeholders of insolvent companies, even in the face of significant opposition. The decisions provide guidance on when an RVO might be the best tool for preserving and realizing value, in circumstances where a traditional approval and vesting order cannot get the job done.

[1] See *Re T. Eaton Co.*, 2000 CarswellOnt 4502, 26 C.C.P.B. 295

[2] (October 7, 2019), Montreal 500-11-057094-191 (Q.C.S.C. [Comm. Div.])

[3] July 13, 2020), Toronto CV-20-00642013-00CL (Ont. S.C.J. [Comm. List])

[4] See also *Plasco Energy* (July 17, 2015), Toronto CV-15-10869-00C (Ont. S.C.J. [Comm. List]), *Wayland Group Corp.* (April 21, 2020), Toronto CV-19-00632079-00CL (Ont. S.C.J. [Comm. List]), *Beleave Inc.* (September 18, 2020), Toronto, CV-20-00642097-00CL (Ont. S.C.J. [Comm. List]), and *JMB Crushing Systems Inc.* (October 16, 2020), Calgary 2001-05482 (A.B.Q.B.)

[5] Arrangement relatif à *Nemaska Lithium inc.*, 2020 QCCA 1488 ("Nemaska Lithium")

[6] Southern Star Developments v. Quest University Canada, 2020 BCCA 364 (“Quest University”)

[7] Nemaska Lithium at para. 39

[8] Quest University Canada, Re, 2020 BCSC 1883 at para. 153

[9] Quest University, at para 154, citing Century Services Ltd. 2010 SCC 60

[10] Quest University, at para 166.

[11] Quest University, at para 171.

[12] Southern Star Developments Ltd. v. Quest University Canada, 2020 BCCA 364 at para 13.

[13] 2020 SCC 10.

[14] Royal Bank of Canada v. Soundair Corp., 4 OR (3d) 1, 83 DLR (4th) 76, 1991 CanLII 2727 (ON CA) at para. 16

[15] Quest University, supra note 10

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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