# Reverse Vesting Orders

An Inquiry into the Emerging Phenomenon and Surrounding Concerns

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## I. Introduction

The CCAA provides Canadian companies facing financial difficulties with the opportunity to restructure their business while maintaining possession of their assets and control of their operations.[1] Traditionally, the debtor's business has been preserved through either plans of arrangement or compromise, or a sale of the business's assets.[2] Over the past few years, the popularity and prevalence of reverse vesting orders (RVOs) have grown immensely.

## II. What is a Reverse Vesting Order?

A reverse vesting order is a type of order used in the sale of a business, that resembles the court-approval and vesting order that occurs in a sale, but with an important twist. In a reverse vesting order, the debtor creates a new company, usually as a subsidiary ("ResidualCo"), and applies to the court to transfer all the liabilities that are unwanted by the purchaser to ResidualCo. This could include things like unwanted contracts and the obligations associated with them. The purchaser agrees to buy the shares in the existing debtor company, on the condition that the reverse vesting order is granted. In acquiring the shares of the existing company, the purchaser becomes the new owner of the debtor's business, and the debtor is released of any obligations associated with the liabilities that have been transferred to ResidualCo. The existing company bought by the purchaser exits CCAA proceedings, and ResidualCo normally enters bankruptcy proceedings.

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[1] Kevin P McElcheran, *Commercial Insolvency in Canada*, 4th ed (Markham, Ont: LexisNexis Canada, 2019) at para 5.1. [*Commercial Insolvency in Canada*].

[2] *Companies Creditors Arrangement Act*, RSC 1985, c C-36, s.6(1) & s.36(1). [*CCAA*].

The key difference to this mechanism is that instead of the desirable assets being vested in the purchaser, the unwanted assets and liabilities are vested out of the company, and into ResidualCo, so that the purchaser can buy the existing company free of unwanted liabilities.[3] This makes the debtor solvent again, as a plan of arrangement would, but without the requirement of a creditor vote.

## III. Why Are Reverse Vesting Orders Useful?

In *Harte Gold*, Justice Penny held that reverse vesting orders are not a "normal or ordinary remedy." [4] Although they are not the norm, reverse vesting orders can be useful where debtor companies have valuable non-transferable characteristics, like licenses and tax losses, that cannot be realized upon a traditional asset sale.[5] RVOs are particularly useful in restructurings involving highly regulated areas requiring government consent, like mining and cannabis, which require government permits and licenses that cannot be transferred or assigned.[6] These types of businesses lose some if not all of their value if these benefits cannot be utilized by a potential purchaser, for without certain permits and licenses, these businesses cannot legally operate.

The benefit that an RVO provides in scenarios like these is that they preserve the existing valuable non-transferable characteristics of the debtor company. This removes the risk associated with the process of reapplying for these licenses and permits, such as the uncertainty that they are granted and the time this process takes, which could be costly to the purchaser by causing a halt in operations until they are granted, leading to lost profits. This entails a further benefit of

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[3] Stikeman Elliott, *Reverse Vesting Orders: Will They Replace CCAA Plans?*, 2021.
[4] *Harte Gold Corp (Re)*, 2022 ONSC 653 at para. 38. [*Harte Gold*].
[5] Pamela L. J. Huff, Linc Rogers & Chris Burr, *Below the Surface: A Deeper Look at Harte Gold and the Future of Reverse Vesting Orders*, Blake's Bulletin, 2022. [*A Deeper Look at Harte Gold*].
[6] *Ibid*.

RVOs, which is that time-effectiveness and certainty, in turn, lead to a more valuable entity, likely increasing the value of potential bids. It is important to note that these same results can be achieved using the normal and ordinary remedy of a plan of arrangement or compromise, which would also preserve the same valuable non-transferable characteristics of the debtor.

Plans and RVOs produce a similar result in that they allow the debtor business to become solvent and exit CCAA proceedings as going concerns, maintaining their valuable, non-transferable business characteristics. These characteristics are not assets, and therefore cannot be collateral or the subject of security.[7] In certain regulated industries they are extremely valuable, and their value, therefore, should be realized by all creditors, and not just secured ones. A plan would result in all classes of creditors receiving some value for these non-transferrable characteristics, for if they did not, they would likely vote against the plan. This is an important reason why plans must maintain their primacy, for their nature ensures a democratic distribution to all creditors of the value of these non-transferrable characteristics, value that secured creditors have no legitimate legal priority over. This value should be distributed democratically to creditors through a plan, which is something that may be lost if RVOs are used in cases that are not 'extraordinary'.

## IV. What Are the Requirements for an RVO?

The justification for the jurisdiction of courts to make RVOs has been addressed by judges in recent cases, and although there isn't unanimity on the statutory source of this power, courts so far have agreed that they have the power to make these orders, and that s. 11 of the Act

[7] *Canadian Imperial Bank of Commerce v Hallahan,* [1990] OJ No 861, 69 DLR (4th) 449, 39 OAC 24, 48 BLR 113, 1 PPSAC (2d) 58, 21 ACWS (3d) 424. at para 4.

gives courts broad powers and the authority to make any order they deem appropriate in the circumstances, provided the order is not restricted by anything else in the Act.[8] The court in *Harte Gold* held that the *Soundair* principles regarding sales of assets apply in the context of reverse vesting orders, but also added additional, non-exhaustive considerations that debtors, purchasers, and monitors must be prepared to answer when seeking court approval, including:

1. Why is the RVO necessary in this case?;
2. Does the RVO structure produce an economic result at least as favorable as any other viable alternative?;
3. Is any stakeholder worse off under the RVO structure than they would have been under any other viable alternative?; and
4. Does the consideration being paid for the debtor's business reflect the importance and value of the licenses and permits (or other intangible assets) being preserved under the RVO structure?[9]

Although the court held that s. 36 does not provide the statutory authority to grant RVOs, Justice Penny held that the factors to be considered in a sale of assets from s. 36(3) should be applied and modified in the context of an RVO.[10] All the factors mentioned that courts use to evaluate whether they will grant approval to an RVO are important to examine, for they provide a warning, foreshadowing the issues and unfairness that are possible, which have now come to light in recent judgments regarding RVOs. The following will be an investigation into these potential issues, addressing concerns that courts are currently grappling with.

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[8] *CCAA*, *supra* note 2 at s.11.
[9] *Harte Gold, supra* note 4.
[10] *Ibid*, at para 37.

## V. Potential Problems with RVOs

Reverse vesting orders are a very powerful mechanism because they have the potential to bypass the statutory protections of creditors, and fundamentally alter the legal relationship of non-consenting entities. Some important issues that arise are the effect RVOs have on the voting rights of creditors, how the value of non-transferable characteristics is distributed, and how to interpret the meanings of 'necessity' and 'extraordinary'.

### 1. Creditor Democracy & the Distribution of Value

A mischaracterization of an RVO would be to understand it as akin to a sale of assets, rather than to a CCAA plan. This is because an RVO provides a similar outcome to a plan, whereby in both scenarios the debtor still owns the business, the untransferable permits and tax attributes persist, and the business exits CCAA proceedings as a viable business. In light of the fact that both a plan and an RVO offer similar outcomes, it is important to examine what is lost when using an RVO when compared to a CCAA plan rather than to a section 36 sale of assets.

S. 6(1) of the CCAA provides for the rules regarding creditor votes on plans. The statute requires a double majority for a successful vote, involving a majority of creditors in number, that also represent two-thirds of voting claims. These rules apply to every class of creditors. S.6(1) effectively gives veto power to any creditor/creditors who total at least one-third of the claims in any given class. This is not a flaw in the statute, but rather, helps further the purpose of the Act contained in the preamble, which is "to facilitate compromises and arrangements between

companies and their creditors".[11] Taken together, the voting rights are meant to help facilitate compromises, by offering leverage to smaller or unsecured creditors, who have the power to vote against a plan and prevent it from going through to the court for approval. This incentivizes the debtor and other creditors to consider the interests of smaller creditors in their proposal and helps unsecured creditors and creditors with smaller claims maintain a voice in the proceedings.

In *Quest University,* the court decided to use an RVO structure because a creditor was likely to veto the plan, and therefore a compromise or arrangement could not be achieved with its creditors.[12] The court in *Quest University*, citing *Callidus* (in the context of creditor voting rights)*,* held that the discretionary authority given to courts under s.11 offers broad powers, and taken with the good faith requirement from s.18.6, permitted courts to bar creditors from voting against a plan, if for an 'improper purpose'.[13]

The logic of this appears to be problematic. The court used an RVO structure because it didn't think the debtor would be able to pass a proposal due to creditor vetoes, while also affirming that it has the authority to bar a creditor from voting if it was not doing so in good faith. If the court has the power to prevent bad faith vetoes, and it was not exercised in this case because the creditor in question was not acting in bad faith, then the use of an RVO is a direct rejection of the democratic voting rights provided to creditors by the CCAA. The creditor in *Quest University* would have been exercising their legal right in voting against a plan in good faith, and there was no evidence that a proposal for a plan had even been attempted. This is at odds with the purpose of the CCAA, and an issue that, alone, should not justify the use of an RVO.

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[11] *CCAA, supra* note 2.
[12] *Southern Star Developments Ltd v Quest University Canada*, 2020 BCCA 364. at paras 103 - 104, [*Quest University*].
[13] *Ibid* at para 155.

This notion is also in line with Justice Penny's third consideration when justifying an RVO, which is whether any stakeholder is worse off under the RVO structure than another viable alternative.[14] Unsecured creditors that do not receive any value for these characteristics are clearly in a worse place than they would have been had a plan been facilitated, and so it seems to follow that a plan should be attempted if at all possible, and only after it has been demonstrated to not be possible, can an RVO be ordered.

Not only do RVOs have the potential to cause this unfairness to unsecured creditors by rendering their voting power useless, jeopardizing their interests, and preventing them of seeing value they should be entitled to, but further, what follows is the reinforcement of the perverse incentive for debtors to negotiate less with their creditors, harming the facilitation of compromises.

Debtors may not negotiate in the same way that they used to before RVOs became an option, because they do not need to negotiate with smaller creditors to secure their vote and ensure a plan passes. With the availability of an RVO on the table, debtors and purchasers can go to a court and ask for this structure, allowing the court to decide on whether a deal is successful, effectively bypassing the voting rights of creditors embedded in the statute. This is a negative effect on the facilitation of compromises between debtors and creditors and is at odds with the purpose of the act.

If this issue is not reigned back by the courts, the potential exists for plans to become redundant, and incentivize any CCAA restructuring involving dissenting creditors to avoid even attempting to negotiate a plan and seek an RVO instead. If debtors are unwilling to negotiate

[14] *Harte Gold, supra* note 4.

with some or all their creditors, it may even be against their own interests, because they may be leaving money on the table.

Less negotiation can also have a negative effect on the value the debtor and its creditors receive through the transaction. In her journal article, *Reverse Vesting Orders - Developing Principles and Guardrails to Inform Judicial Decisions*, Professor Janis Sarra argues that negotiations and a vote help lead to higher value being paid in the restructuring.[15] This is because, without negotiation and a vote, purchasers get the forward value of the companies' business, while the creditors whose claims get transferred to ResidualCo get none of that forward value.[16] If a vote is required, these interests would likely be taken into account and could result in a greater price for the debtor. If a vote fails, it does not end the negotiation process, and is therefore not a reason to jump to an RVO structure to make a deal. Therefore, an RVO structure may result in less negotiation, and therefore money left on the table for creditors.

2. Interpreting "Necessary" and "Extraordinary"

The first indicia Justice Penny outlined in *Harte Gold* for courts to consider is whether the RVO is necessary in this case.[17] What 'necessary' means in the context of an RVO should be considered carefully, because a loose definition can result in unfairness to the unsecured creditors whose claims are likely to be vested out into ResidualCo. When 'necessary' is in reference to the non-transferable characteristics possessed by a company, the necessity of an RVO structure is not justifiable, for a plan would result in the preservations of these

[15] Janis P Sarra, *Reverse Vesting Orders – Developing Principles and Guardrails to Inform Judicial Decisions*, Canadian Legal Information Institute, 2022 CanLIIDocs 431.
[16] *Ibid.*
[17] *Harte Gold, supra* note 4.

characteristics. But what about when necessity is referring to the RVO offer being the only way to make a deal, or when an RVO offer is the only one available?

This echoes the concerns from earlier in the paper regarding the court in *Quest University* granting an RVO for a plan that would have failed, because it would have been vetoed by certain creditors. Is this enough to create the 'necessity' of an RVO? This raises concerns about necessity based on suspicions of a failed plan and appears to be too low of a bar to implement an RVO, and effectively overrule creditor democracy. Plans should be the default mechanism, based on the purpose of the legislation, and considering what is lost regarding creditor rights when using an RVO rather than a plan, the meaning of necessity and 'extraordinary' should be interpreted as meaning the RVO is the only way to preserve the added value of these non-transferable characteristics, after a plan has failed.

Democracy is the default mechanism embedded in the legislation, and therefore it seems that evidence that a plan had be attempted and failed should be brought to the court before being able to justify it as an 'extraordinary' circumstance with the requisite necessity required for an RVO. In *Quest University,* the court ordered the RVO because they believed a plan would fail based on a creditor veto but were not required to have even attempted a plan, or produce evidence that this was the case.[18] Going forward, courts should consider requiring a plan to fail first, or at least for the parties requesting the RVO to produce evidence that the plan would have failed. This would be in harmony with the purpose of the act, and would align with the notion that plans are the 'ordinary' mechanism, and that 'extraordinary' circumstances would mean a plan failed or would have failed, accompanied by the reality that there is greater value for all parties if the non-transferable characteristics are preserved.

[18] *Quest University*, *supra* note 11.

What about 'necessity' with respect to only receiving one offer? The court in *Quest University* held that the RVO was necessary because "no other options [were] before the stakeholders and the Court that would suggest another path forward".[19] This too seems to be something courts should consider cautiously, because of the implications it has on the rights of creditors to vote on outcomes. Careful investigation needs to be done for courts to determine that time constraints and pressure from the purchaser have not created a false sense of necessity.

Although the court in Ontario has not addressed this question, the BCSC recently rejected an RVO, based in part on the rejection of its necessity. In *Payslate,* the argument that an RVO was necessary in part because it would preserve the business as a going concern failed, because evidence showed that it planned to fire most of its staff.[20] Although not directly applicable to this concern, it is good to see a court questioning the necessity of an RVO, and looking deeper into the reasons necessity is claimed.

## VI. Closing Thoughts

RVOs are a recent phenomenon in Canadian insolvency law and have yet to be explored thoroughly by courts. They are very useful in specific contexts and provide a creative solution to complex problems involving valuable non-transferable characteristics. In light of this, RVOs must remain reserved for particular scenarios requiring this 'unusual and extraordinary measure', to prevent CCAA plans from becoming obsolete, to help facilitate negotiations, and to protect the voting rights of creditors.

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[19] *Quest University*, *supra* note 11 at para 158.
[20] *PaySlate Inc (Re)*, 2023 BCSC 608 at paras 115-124.

Plans are optimal because they require consensus, and the CCAA is designed to create democracy and distribute value based on consensus. Because democracy is lost through an RVO, the question that ultimately needs to be answered in justifying its use is why a plan was not successful. Courts should require evidence for why this is the case, to show that the ordinary mechanism of a plan was tried first. The progressing case law will help flesh out further considerations, as more judgments are released, and as more RVOs are both approved and rejected. One thing is for sure though, reverse vesting orders are now an important feature of Canadian insolvency law and are not going anywhere.

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