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Reverse vesting orders: Popular in Canada and going international?

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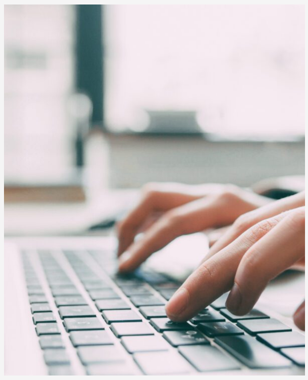

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Authors: Marc Wasserman, Jacqueline Code

Since we last discussed the then-novel restructuring mechanism known as the reverse vesting order (RVO) in 2020, insolvency professionals have been seeking, and courts have been approving, this facilitative remedy with greater frequency. Two particularly notable decisions rendered in 2022 – *Harte Gold* and *Just Energy* – show how far the case law has come in the last two years.

Both *Harte Gold* and *Just Energy* have provided valuable guidance with respect to the circumstances in which *Companies' Creditors Arrangement Act* (CCAA) courts will approve an RVO transaction. This guidance confirms that RVOs are clearly taking their place on the menu of options for restructuring an insolvent company, particularly where that company operates in a highly regulated space. Both cases also confirm the availability of a broad release, in the context of an RVO, for the benefit of the debtor and certain third parties who contribute to the restructuring or whose claims must be finally resolved to give effect to the restructuring.

Finally, *Just Energy* is the first example of an RVO transaction to obtain recognition under Chapter 15 of the U.S. *Bankruptcy Code*.

What is an RVO?

In Canada, the CCAA is the tool of choice for restructuring large and complex insolvent corporations, with the two typical outcomes being (a) a plan of compromise or arrangement or (b) the going-concern sale of the business.

Going-concern sales under the CCAA are traditionally undertaken through the transfer of assets of the debtor to a purchaser free and clear of liabilities, other than those expressly assumed by the purchaser. Sale approval and vesting orders approve the sale of the business and the vesting of the purchased assets in the buyer. In a typical asset sale, the sale proceeds remain in the hands of the debtor company to stand in place of the assets and to be distributed to creditors in accordance with applicable legal priorities.

In contrast, an RVO transfers most or all of the debtor's liabilities to a new "residual corporation," while most or all of the assets and any assumed liabilities remain in the debtor corporation. The purchaser becomes the sole shareholder of the now-cleansed debtor company which can exit the insolvency proceeding on a going-concern basis. The liabilities that the purchaser does not assume are transferred to the new residual corporation, as well as any assets that the purchaser elects to leave behind. It can then be liquidated using a CCAA plan or wound up through a bankruptcy or similar process.

One of the major benefits of an RVO is that there is no transfer of intangible assets, such as regulatory permits, licences or similar rights, or key contracts that are necessary to operate the business as a going concern. As a result, an RVO can often avoid the need for the purchaser to obtain consent from regulators or counterparties for the transfer or assignment of a licence or a contract, respectively – something that would generally be required in a traditional asset sale, assuming the licence or permit is transferable at all. Thus, an RVO can significantly accelerate the timing for completion of a restructuring, while reducing risks of lost value to the business (and to the restructuring as a whole) if consents have to be obtained or the purchaser has to reapply for new licences and renegotiate key contracts.

Harte Gold: Important guidance on key factors for approving an RVO

In December 2021, Ontario gold mining developer, Harte Gold Corp. (Harte Gold) commenced proceedings under the CCAA. From the outset, the debtor's plan was to achieve a going-concern sale of its business, with the pre-filing secured lender serving as the stalking horse bidder in a sales process that culminated with the stalking horse bid being declared the winning bid.

The stalking horse bid was structured as a share subscription agreement with an RVO. The end result was the purchaser became the sole shareholder of Harte Gold's business, which was divested of certain assets, contracts and liabilities that were assigned to a residual corporation. The RVO structure was argued to be necessary instead of a traditional asset sale approach in order to maintain Harte Gold's multitude of contracts, licences and mining-related claims, such as mineral claims.

The parties sought approval of the sale and the RVO from the CCAA court. In granting the requested relief, Justice Penny delivered the first written endorsement from an Ontario CCAA court on the subject, providing detailed guidance on the circumstances in which an RVO can be appropriate. The CCAA court found that, while RVOs should not be the "norm" in restructurings, and should not be used merely because of convenience, they can be an appropriate way for a debtor to sell its business as a going concern where the circumstances justify such a structure.

When seeking approval of a reverse vesting order, Justice Penny explained that the parties should be prepared to explain (i) why the RVO is necessary, (ii) whether the structure produces an economic result at least as favourable as any other viable alternative, (iii) whether any stakeholder is worse off under the RVO structure than under a viable alternative and (iv) whether the consideration provided by the acquiror reflects the importance and value of the assets being preserved under the RVO structure. Justice Penny found that those questions had been favourably addressed and that the sale was otherwise appropriate in the circumstances. He therefore granted the RVO.

Harte Gold has quickly become the standard other courts use to assess the appropriateness of reverse vesting order transactions, including in *Blackrock Metals*, *Port Capital Developments*, and now *Just Energy*, which has set the stage for the next step in RVO case law.

Osler acted for the pre-filing secured lender who became the sole shareholder of Harte Gold.

Just Energy: RVOs and Chapter 15 of the U.S. *Bankruptcy Code*

In March 2021, Just Energy Group Inc. and certain of its affiliates (Just Energy) commenced proceedings under the CCAA. The CCAA proceeding was subsequently recognized under Chapter 15 of the U.S. *Bankruptcy Code*, given that a significant portion of Just Energy's business is conducted south of the border.

Just Energy is a retail energy provider. It operates in a highly-regulated environment. At the time of the CCAA court's decision, it held more than 80 permits, licences and other rights necessary to carry on its business in Canada and the U.S. It was also party to a number of key contracts. In addition, its licences and permits were either not transferable at all or required regulatory consents for any transfer – or in some instances, there was no clear process to effect their transfer. Similarly, its key contracts were either not assignable or required the consent of the counterparty. By contrast, a change of control generally imposed much less onerous reporting or notice requirements.

Just Energy originally intended to exit its CCAA and Chapter 15 proceedings through a plan of compromise or arrangement that would have restructured the debtor companies on a going-concern basis. However, support for the proposed plan was withdrawn by the plan sponsor and certain stakeholders following the CCAA court's decision that a valuation of certain unsecured contingent claims would have to be conducted prior to the creditor meetings.

Following the failure of the plan, the only available means to achieve a going-concern exit from the CCAA was to test the market through a sale or investment solicitation process (SISP), with the purchaser (former plan sponsor) acting as a stalking horse bidder in the process. No superior bids materialized during the 10-week marketing process. The stalking horse bid, which contemplated the sale of the business through an RVO structure, was declared to be the successful bid.

The Ontario CCAA court was then asked to approve the sale of the business by means of the RVO. Justice McEwen agreed with the reasoning in *Harte Gold* that the jurisdiction to approve an RVO derives from section 11 of the CCAA, which gives the CCAA court the authority to make any order that it thinks fit, in the interests of the restructuring. Justice McEwen also agreed that the court must have regard for the factors under section 36(3) of the CCAA, which applies where the debtor company is selling assets out of the ordinary course of business, and to the well-known test in *Royal Bank of Canada v. Soundair Corp*. The relevant factors generally require, among other things, that the court be satisfied that the process has been fair and that reasonable efforts have been made to maximize value.

Echoing comments in *Harte Gold* about when the court's authority should be exercised to approve an RVO, Justice McEwen noted that courts must carefully consider whether an RVO is warranted in the circumstances. He identified the pattern of past circumstances in which such an order has been granted – namely, where the debtor operates in a highly-regulated environment or is a party to certain key agreements that would be difficult or impossible to assign to a purchaser, or where maintaining the existing legal entities would preserve certain tax attributes that would be otherwise lost in a traditional vesting order transaction.

Without determining that these are the *only* circumstances in which an RVO will be granted, Justice McEwen concluded that, in Just Energy's circumstances, the RVO was the only way to preserve the licences, authorizations and other rights necessary to continue the debtors' business as a going concern. The evidence was undisputed that transferring those licences, permits or contracts would be impossible or extremely difficult. Moreover, the costs, risks and delay of having the purchaser re-apply for those permits or licences and renegotiate key contracts would jeopardize the going-concern restructuring. There were also U.S. tax attributes and hedging relationships that would be preserved under the RVO transaction. Finally, Just Energy had been in the CCAA and Chapter 15 proceedings for approximately 19 months and time was not on its side.

Based on these facts, among others, the CCAA court granted the reverse vesting order. It had been amply demonstrated that there was no other going-concern transaction available in the market. The court noted that the RVO transaction did not generate any recoveries for the general unsecured creditors. However, Justice McEwen accepted that this was not as a result of the RVO structure, but rather, of the fact that the market demonstrated that the value of the debtor companies' businesses was not sufficient to generate recoveries for the unsecured creditors after satisfying priority claims.

The evidence demonstrated that the market had been fully canvassed and that the consideration received from the purchaser was fair and reasonable. Had the debtors proceeded by way of a liquidation, rather than the RVO transaction, there would have been a shortfall for secured creditors, in addition to no recovery for unsecureds. The RVO also had a number of other benefits, including the preservation of almost 1,000 jobs and numerous relationships with customers, suppliers, vendors and other stakeholders.

Consistent with prior practice in RVO cases, the court also approved a broad release in favour of the debtor companies, as well as certain third parties whose contributions to the restructuring satisfied the test for third-party releases established in CCAA case law.

Significantly, on December 1, 2022, the debtors sought and obtained recognition of the RVO in the U.S. Bankruptcy Court. This is the first example of a U.S. court recognizing a Canadian RVO in the United States.

Osler acts for Just Energy.

Future prospects for RVOs

We expect that reverse vesting orders will continue to be popular in Canada. Their recognition in a U.S. cross-border proceeding creates additional opportunities for their use in complex, international restructuring proceedings. With the additional guidance provided by CCAA courts this year, we expect that this relief will continue to be a valuable tool in circumstances where the nature of the debtor's business justifies the RVO structure.