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Notable developments in insolvency law: Flexible tools for challenging times

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Along with a tense election south of the border, 2020 brought COVID-19 and its attendant devastating loss of life and far-ranging economic implications, both positive and negative. The world now looks to 2021 with significant uncertainty with respect to what comes next. Certain sectors of the economy, in particular, may be irreparably damaged. Many people are anticipating that restructuring and insolvency law will loom large in 2021 and beyond, and that creative solutions will be required to address the myriad issues that financially distressed businesses face. We have distilled some notable themes in restructuring law that we believe will continue to apply and evolve in both the near and long term.

Debt restructurings under the CBCA: A flexible tool to address market disruption

For over-leveraged companies looking to avoid the time, costs and reputational implications associated with an insolvency filing, a "balance sheet restructuring" under the *Canada Business Corporations Act* (CBCA) or a provincial equivalent provides a valuable alternative. CBCA debt restructurings continue to gain popularity as flexible tools for reducing total indebtedness and preserving going-concern value, although they are usually not the right choice where a company needs operational restructuring (i.e., to address supplier, customer, employee, pension or environmental issues).

This year, several notable proceedings advanced or refined the law that applies to CBCA restructuring transactions. In all three examples, stakeholders voted on the corporate plan of arrangement against the backdrop of the debtor's stated intention to file under the *Companies Creditors' Arrangement Act* (CCAA) to complete the same recapitalization transaction if the CBCA recapitalization failed. In a CCAA proceeding, certain stakeholders – principally, shareholders and so-called "equity" claimants whose claims derive from their status as shareholder – would receive no recovery if creditors, including the holders of debt securities, were not being fully repaid. In the three cases below, the benefits of the particular plan under the CBCA were therefore evaluated, in part, against this likely alternative outcome.

Just Energy

In 2020, Just Energy Group Inc. (Just Energy), an energy retailer business with operations in both Canada and the U.S., completed a CBCA restructuring. This case is a welcome addition to the line of cases in which the courts have adopted a flexible approach to the CBCA to assist a near-insolvent corporation in rehabilitating its balance sheet. Osler acted for Just Energy.

The Just Energy restructuring plan involved the exchange by senior debt holders of a portion of their debt for a combination of debt and equity in a newly capitalized corporation. The existing holdings of both common and preferred shareholders were also exchanged for equity in the new corporation, though these interests were significantly diluted by the equity issued to the debt holders. The plan was approved without objection from these stakeholders.

The Just Energy final order granted broad releases in favour of Just Energy, including in relation to all holders of “equity claims,” i.e. persons with litigation claims against the debtor arising from losses experienced by virtue of their status as shareholder. The plan limited recovery for certain of such “equity” claims to the proceeds of the company’s insurance policies that provided securities claim coverage. Those claims arose from several securities class proceedings against Just Energy in which the plaintiffs claimed significant damages for loss of share value as a result of financial irregularities and the company’s subsequent corrective disclosure.

The Just Energy recapitalization occurred over a mere three-month period from the date that the preliminary interim order (July 2020) was granted by the Ontario Superior Court of Justice to the date the transaction closed (September 28, 2020). This expedited time period demonstrates the potential efficiency of a CBCA debt restructuring in appropriate circumstances, as compared to a filing under the CCAA or the *Bankruptcy and Insolvency Act* (BIA).

Calfrac

While the CBCA restructuring of Calfrac Well Services Ltd. (Calfrac) remains ongoing as of the time of writing, we have already gleaned some important lessons from this proceeding.

As in Just Energy, the Calfrac recapitalization involved an exchange of senior unsecured debt securities for equity. Existing common shareholders were entitled to elect to receive cash plus warrants for their common shares, or to retain their shares and receive warrants. This recovery for shareholders was more favourable than would be available in a CCAA filing. The arrangement did not affect the senior secured debt.

Calfrac also conducted a new notes offering to partially refinance indebtedness outstanding under the company’s credit facilities, to satisfy the cash component of the recovery for shareholders, as well as to provide working capital.

Unlike in Just Energy, the fairness and reasonableness of the final order was contested. The company had received a take-over offer for its shares from Wilks Brothers LLC, a potential rival which already held approximately 20% of the Calfrac shares and which had sought a strategic partnership prior to the CBCA filing. Wilks Brothers objected at the final order hearing. It had previously unsuccessfully sought to vary the interim order and was not successful in its appeal from that decision.

The board, on the advice of the special committee, did not recommend acceptance of the

Wilks Brothers offer by shareholders on the grounds that the arrangement transaction was the superior proposal. The take-over offer, in contrast, required the waiver of the statutory minimum condition for take-over bids and did not address the company's obligations under its senior unsecured notes ranking in priority to the shareholders. Both factors were determined to be serious barriers to completion. The Alberta Court of Queen's Bench approved the CBCA plan on October 30, 2020, on the basis that it was fair and reasonable, in accordance with the applicable test.

Wilks Brothers appealed the final order, challenging the finding of fairness and reasonableness, as well as the waiver provision in the plan. The appeal was heard by the Alberta Court of Appeal on November 25, 2020. The Court of Appeal dismissed the appeal and issued reasons on December 1, 2020, which among other things highlighted that courts highly value the facilitative nature of the CBCA and that counsel should keep the purpose of the CBCA front of mind when structuring these transactions.

iAnthus

A case that seems to go against the more facilitative trends in the CBCA restructuring cases is the arrangement involving iAnthus Capital Holdings Inc. (iAnthus). The British Columbia Supreme Court initially refused to grant a final order approving the proposed recapitalization of iAnthus. The principal objection of the Court related to the scope of the third-party releases contained in the plan of arrangement. In this respect, the B.C. Court took a narrower approach to the permitted scope of such releases than the courts in other similar restructurings under the CBCA. An important distinction in this case is that the plan was proposed under the provisions of the British Columbia *Business Corporations Act* (BCBCA), which is less commonly used for such restructurings than the CBCA.

The BCBCA plan, as initially proposed, contained a broad release that would have immunized iAnthus and others from, among other things, claims advanced in certain securities class actions that pre-dated the strategic review and the BCBCA proceeding. However, there was no provision for channelling recovery for such claims into applicable insurance policies.

In lengthy reasons, the Court concluded that the arrangement was fair and reasonable, apart from the breadth of the release, which would have barred claims of historical shareholders that preceded the plan of arrangement. The Court was of the view that the BCBCA did not permit a release that would protect the company against claims from third parties unconnected to the plan.

Following this setback, the company revised the plan to narrow the scope of the release and returned to Court seeking approval of the amended plan. Over the continued objections of two stakeholders, the Court nonetheless approved the revised plan.

The Court rejected the argument that the revised plan had to be resubmitted to shareholders for their approval. The Court also clarified its earlier reasons, indicating that it had not concluded that all provisions affecting the rights of third parties were not permitted under the BCBCA. Consistent with prior BCBCA case law, the Court indicated that an order under the BCBCA affecting third parties can be approved where it is ancillary to and necessary to implement the plan of arrangement. This softening of the original position should help preserve flexibility in future corporate statute debt restructurings.

The Court was satisfied that the terms of the revised release were sufficiently connected and ancillary to the plan that the persons bound by the release all benefitted from the plan. The revised plan was therefore approved. At the time of writing, we understand that certain of the objectors may be considering an appeal.

Whether the narrower approach adopted by the Court to the powers under the BCBCA to grant a broad third-party release will have relevance outside British Columbia or in circumstances where third-party recovery is channelled to an insurance policy remains to be seen. It is hoped that Courts under the CBCA will continue to adopt a more pragmatic approach – particularly where the result of a failed corporate arrangement will only serve to drive the company into a more costly, time-consuming insolvency filing, to the detriment of all stakeholders, and shareholders in particular

Working around the anti-deprivation rule

Businesses increasingly ask how they can protect themselves from the fallout of their contractual counterparties' insolvencies. With increased uncertainties for many businesses, the COVID-19 pandemic has heightened these concerns. At the same time, the Supreme Court of Canada (SCC) has now further narrowed an already limited suite of protections for the non-insolvent contractual counterparty.

In *Chandos Construction Ltd. v. Deloitte Restructuring Inc.*, released in October 2020, the SCC confirmed that the common law anti-deprivation rule applies in Canada. The rule invalidates contractual provisions that, based on an insolvency trigger such as a bankruptcy filing or a receivership, operate to remove value from the insolvent party's estate that would otherwise be available to creditors. This includes, for example, a clause that requires one party to pay an amount to the other party as a result of that party's insolvency. The application of this rule is now demanding further creativity from contracting parties who were already experiencing pressure to protect themselves against a counterparty insolvency in the uncertain environment created by the COVID-19 pandemic.

At issue in *Chandos* was a clause in a stipulated price construction subcontract that provided for the forfeiture by the subcontractor, Capital Steel, of 10% of the subcontract price to the contractor, Chandos, on the insolvency, bankruptcy, receivership, winding up or other distribution of assets of Capital Steel. This amount was stated to be a fee "for the inconvenience of completing the work using alternate means and/or for monitoring the work during the warranty period." Capital Steel's trustee in bankruptcy argued that the forfeiture was invalid either under the anti-deprivation rule or the rule against contractual penalties. The majority of the SCC agreed, based solely on the anti-deprivation rule.

Justice Rowe, writing for the majority, held that the anti-deprivation rule is violated where (a) a contractual clause is triggered by an event of insolvency or bankruptcy; and (b) the effect of the clause is to remove value from the insolvent's estate. The majority rejected the idea that a bona fide commercial purpose could save otherwise invalid clauses – for example, on these facts, the potentially genuine commercial concern that the increased costs might be incurred by Chandos as a result of Capital Steel's insolvency.

After *Chandos*, what can contracting parties do to protect against a counterparty's insolvency? According to Justice Rowe, certain types of protective clauses may not violate the rule – namely, clauses that eliminate property from the estate, but do not eliminate value, or that are triggered by an event other than insolvency or bankruptcy. Similarly, there is no violation of the rule in contractual protections that involve taking or enforcing security or requiring insurance or a third-party guarantee. However, the decision provides little guidance about the scope of these exceptions. The types of protective measures that can be adopted to address a counterparty insolvency without violating the anti-deprivation rule remain to be worked out by contracting parties and (perhaps) further tested by the courts.

Leave to appeal a CCAA decision is hard to get

In the CCAA restructuring of Delphi Energy Corp. (Delphi), the Alberta Court of Appeal has provided useful, recent confirmation of the very high bar that a complainant must meet in seeking leave to appeal from an order made by the supervising judge approving a CCAA plan of arrangement as fair and reasonable. Contested CCAA sanction hearings are uncommon and appellate courts therefore rarely have the opportunity to provide meaningful guidance with respect to issues raised at this final stage of a CCAA proceeding. Osler acted for Delphi.

In *Re Delphi Energy Corp. and Delphi Energy (Alberta) Limited,* the Alberta Court of Queen's Bench approved a plan of compromise and arrangement that had received the statutorily required levels of approval from affected creditors. The Alberta Court of Appeal subsequently denied leave to appeal from this order in separate applications from two stakeholders. The Court of Appeal confirmed prior law providing that an appeal court will not lightly disturb a determination that a plan of compromise and arrangement is fair and reasonable, given the delicate balancing exercise required in making this finding. The Court of Appeal also noted that any delay represented by the proposed appeal would almost certainly imperil the going-concern restructuring of Delphi.

In *Trican Well Service Ltd. v. Delphi Energy Corp.,* the Court of Appeal dismissed an application for leave to appeal brought by certain trade creditors. These creditors alleged that their unsecured claims had been improperly classified for voting purposes in the same class as the so-called "convenience" class creditors, thereby overwhelming their voting power. They also argued that the classification improperly subordinated their builders' lien rights to the interests of other debtholders. The "convenience" class creditors had unsecured claims valued at $5,000 or less, as compared to the trade creditors who were owed several million dollars. Under the plan, the "convenience class" claims were paid in full and these creditors were deemed to vote in favour of the plan. The objecting creditors could have opted into the convenience class, but chose not to, on the basis that they sought recovery of more than the $5,000 limit.

Although convenience classes have been frequently used in CCAA plans, there are very few, if any, examples of cases in which the appropriateness of such a mechanism has been raised before an appellate court. In concluding that this ground of appeal had no likelihood of success, the Court of Appeal held that, if leave to appeal were granted, the conclusion of the CCAA judge that creditor classification under the plan was appropriate would receive a very high degree of deference. The Court of Appeal confirmed the principle that classification should be based on commonality – not identity – of interest, and that fragmentation of classes should not be used to confer veto power on one stakeholder group.

The Court of Appeal also concluded that there was no reasonable prospect for the objecting creditors to establish that the plan improperly compromised their claims against Delphi's directors. Section 5.1(2) of the CCAA precludes a debtor from compromising certain types of claims against directors – principally those that are based on allegations of misrepresentation or wrongful or oppressive conduct. The Court of Appeal held that the plan mechanism whereby claims against Delphi's directors were limited to the proceeds of the debtor's insurance policies was not a compromise of the claims against the directors at all. The insurance limits were more than sufficient to cover those claims, even if they were entirely successful. This ground of appeal therefore also had no hope of success.

The second application, *Repsol Canada Energy Partnership v Delphi Energy Corp.,* involved a leave to appeal motion from a creditor holding certain indemnity claims against the debtor. In denying leave to appeal, the Alberta Court of Appeal confirmed that claims originating in pre-filing obligations but coming due during the post-filing period can be compromised under a CCAA plan.

“Reverse” vesting orders are a viable restructuring mechanism

Reverse vesting orders are one of the newer, more exciting developments in restructuring law this year, having only been in use for a short period and picking up steam quickly. We are aware of only half a dozen or so cases featuring reverse vesting orders. Most have occurred over the past 18 months. The popularity of this new tool continues to rise, particularly in highly-regulated industries such as mining and cannabis.

A traditional vesting order transfers the assets of the debtor corporation to a purchaser, leaving liabilities behind. A “reverse” vesting order (RVO) transfers the debtor’s liabilities to a new “residual corporation,” while the assets and any assumed liabilities remain in the debtor corporation. The debtor generally continues to operate as a going concern, with the support of new investors or investments. The new residual corporation can, if appropriate, develop a plan under the CCAA to compromise the remaining liabilities.

Both traditional vesting orders and RVOs are frequently implemented at the end of a court-approved sale or investment solicitation process (SISP).The advantages of an RVO are generally twofold. Complex assets – for example, permits, approvals or key agreements, such as agreements with Indigenous peoples – can be challenging to transfer successfully to a third-party purchaser as a result of regulatory limitations or consent requirements. Moreover, an RVO can preserve tax attributes that would be lost in a more traditional asset sale. The RVO therefore provides a potentially less cumbersome mechanism for allowing a debtor company to preserve going-concern operations, including for the benefit of employees and other vulnerable stakeholders. Notably, RVOs carry additional structuring complexities that may make them less attractive where these factors are absent.

RVOs have been used in a number of recent CCAA restructurings, including in the CCAA proceedings of Comark Holdings Inc. et al, (Ontario, 2020), Wayland Group Corp et al, (Ontario, 2020) and Stornoway Diamond Corporation et al (Quebec, 2019). Osler acted for the debtors in the Comark and Wayland matters, and for the monitor in Stornoway.

Until the Québec Superior Court’s decision in *Arrangement relatif à Nemaska Lithium inc.*, these transactions had been completed on consent. In *Nemaska*, the Court approved an RVO transaction structured as a credit bid by the debtors’ secured creditors over the strenuous objections of one stakeholder.

The Court recognized that the proposed transaction was both complex and innovative, holding that flexibility is required in finding solutions to the issues facing an insolvent debtor. The Court was satisfied that a fair process had been followed and that sufficient efforts had been made to obtain the best offer. The only alternative to the proposed RVO was liquidation, which would be catastrophic for all stakeholders.

The objecting stakeholder (a shareholder and creditor of Nemaska) argued that section 36 of the CCAA only permits a vesting order to “vest out” encumbrances on the debtor’s assets in the context of a sale or disposition of assets to a third-party purchaser. The Court disagreed, holding that there is no such limitation. Since the proposed transaction was beneficial to the debtor’s stakeholders, there was no reason that the Court could not apply section 36(6) of the CCAA to effectively discharge the liabilities or other encumbrances that might otherwise attach to the debtor’s assets by means of the RVO.

Leave to appeal to the Québec Court of Appeal was subsequently denied. Although the Court of Appeal considered that the basis for granting the RVO and the potential objections could be of interest to the insolvency profession, the Court refused to allow the RVO to be appealed. The objecting stakeholder’s application appeared to be motivated primarily by

tactical considerations. Moreover, any delay resulting from the appeal would likely jeopardize the restructuring.

The decisions in *Nemaska* provide welcome comfort to debtors – particularly those operating in highly-regulated sectors – who seek to take advantage of the benefits this structure offers. The specific advantages of an RVO were important to Nemaska, as a lithium mining company conducting business in Northern Québec pursuant to numerous permits and approvals, as well as agreements negotiated with the nearby Cree First Nation.

Conclusion

Courts are clearly grappling with the need to ensure that businesses in financial difficulties have the flexible tools available to restructure successfully for the benefit of all of their stakeholders. At the same time, principles of fairness must be respected, despite the extreme pressure experienced by insolvent companies to preserve value for all concerned and the attempts by particular stakeholders to protect their interests. As the economic consequences of COVID-19 continue to be felt, we expect that the ingenuity of parties, their counsel, the courts and perhaps the legislatures will be put to the test.