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Hitting reverse: B.C. Court refuses to grant a reverse vesting order

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With the recent flurry of reverse vesting orders (RVOs) in Canadian insolvency proceedings in the last two years, courts have warned against over-use of this distressed M&A structure. In *PaySlate Inc. (Re)*, 2023 BCSC 608, the Supreme Court of British Columbia hit reverse. The Court, in reinforcing the judicial view of RVOs as an extraordinary remedy rather than a new norm, refused to grant an RVO and its related releases and claims bar, and provided further guidance as to the circumstances when a court should, and should not, grant an RVO.

What you need to know

- The Supreme Court of British Columbia refused to grant an RVO because, among other reasons, the debtor: (i) did not provide adequate notice to creditors whose claims would be impaired by the transaction; (ii) failed to establish that the RVO was sought for a proper purpose; and (iii) did not support the transaction with fulsome valuation evidence to demonstrate that it was necessary and appropriate in the circumstances.
- The Court did not take issue with, or dispute the conclusions set out in, any of the recent cases on RVOs across the country—rather, it applied those cases and principles to the facts at hand.
- In evaluating whether to grant an RVO, the Court enumerated additional factors to weigh in addition to those established in recent cases and confirmed that the same considerations that have been previously applied in the context of the *Companies' Creditors Arrangement Act* (CCAA) also apply in other insolvency contexts, including under the *Bankruptcy and Insolvency Act* (BIA).
- The Court emphasized not only the role of the debtor but also the court officer in satisfying the court as to the appropriateness of the RVO.
- The Court's decision follows the judicial trend of treating RVOs with a heightened degree of scrutiny and granting them only in appropriate, extraordinary circumstances.

The details

Background

This case illustrates circumstances in which a court will refuse to grant an RVO.

PaySlate Inc. is a technology company that provides online property rental payment processing services, primarily to owners and managers of real property. Its assets are comprised almost entirely of "soft" assets—customer service agreements, intellectual property, its workforce and certain tax attributes consisting of tax credits and scientific research and experimental development tax credits. Due to financial distress, PaySlate filed a notice of intention to make a proposal to its creditors under the BIA in December 2022.

Following an unsuccessful court-approved sale and investment solicitation process (SISP), PaySlate entered into a share purchase agreement with its debtor-in-possession lender (the Purchaser), under which the Purchaser would acquire all of PaySlate's shares through an RVO transaction. Importantly, the Purchaser was an insider that shared the same key principal as PaySlate.

PaySlate's RVO transaction was opposed by one of PaySlate's unsecured critical suppliers, which argued, among other things, that PaySlate had failed to give appropriate notice to its creditors, establish that the RVO was necessary to continue its business as a going concern and prove that there was no viable alternative to the RVO transaction that might leave stakeholders better off.

Key issue

The key issue was whether the proposed RVO transaction met the requirements for court approval.

The Court's decision

The Court refused to grant the RVO.

The Court echoed the judicial view that RVOs are not the norm and should be granted only in extraordinary circumstances. Building on recent RVO decisions such as *Harte Gold*, *Quest University Canada* and *Just Energy Group Inc.*, the Court recognized that heightened scrutiny and diligence must be applied to RVOs because they lack many of the key statutory safeguards that normally provide economic stakeholders with a "voice" in the debtor's restructuring. For example, a proposal under the BIA or a plan of arrangement under the CCAA both give unsecured creditors their voice by entitling them to vote on the debtor's proposed path forward; RVOs do not. While RVOs are appropriate in limited circumstances, such as for preserving non-transferrable assets like licenses, intellectual property and tax attributes, they are not a one-size-fits-all solution.

Accordingly, in addition to the guidance provided by those recent decisions and the factors set out in section 36(3) of the CCAA (and the analogous *Soundair* factors), the Court added that:

- creditors should get an opportunity to have their voices heard in the workout strategy, notwithstanding the lack of a statutory vote mechanism;
- courts should be mindful that RVOs remove the "forward value" of the debtor's activities from its creditors, whose claims are channeled to a "residualco" structure with recourse only to a limited pool of assets;
- an evidence-based rationale should be provided to explain why the RVO is at least equivalent to outcomes under the statutory mechanisms (such as a proposal or plan of arrangement); and
- careful consideration should be given to any proposed releases and ancillary relief where creditors do not receive the opportunity to vote.

With these factors in mind, the Court held that PaySlate had failed to establish that the RVO transaction met the

requirements for approval.

First, PaySlate had failed to serve notice of its RVO transaction on the contractual counterparties whose rights would be impaired. Those counterparties would have been required to carry on providing services to PaySlate, but with restricted contractual rights, a broad release of their pre-filing claims against PaySlate and certain third parties (other than cure costs channeled to a residualco-style creditor trust) and a risk of not being fully paid for post-closing services by a troubled debtor. The Court rejected PaySlate's arguments that service would be unduly burdensome, given particularly that PaySlate intended to provide notice to those counterparties after the retention of their contracts had been approved anyway.

Second, the Court was not satisfied that the RVO transaction was truly meant to preserve PaySlate's business as a going concern. This issue primarily arose from what the Court viewed as an incompatible position. On the one hand, PaySlate submitted that, being a business with minimal "hard" assets, its employees were a critical component of its value and ability to operate as a going concern. On the other hand, PaySlate intended to terminate half of its workforce in connection with the transaction. The Court thus found PaySlate's and the Purchaser's evidence regarding the purpose of the RVO problematic.

Finally, the evidence submitted by PaySlate and the Proposal Trustee regarding the value of PaySlate's tax attributes—some of its largest assets—was not fulsome enough to determine that there was no viable alternative to the RVO transaction that might leave stakeholders better off. While the Proposal Trustee had filed a supplemental report shortly before the hearing, the report did not identify the sources for much of the valuation information, nor did it provide the qualifications or expertise of its author. While not every case involving an RVO may require expert valuation opinions, at a minimum, robust evidence concerning the value of the assets, including its tax attributes, should have been provided well before the hearing began. Here, the value could also not be inferred based on what the Purchaser was willing to pay for it, even though there were no successful bids following the SISP.

Implications

The Court's guidance in *PaySlate* illustrates that RVOs do, indeed, have their limits. Given the emerging widespread judicial view that RVOs are an extraordinary measure, parties seeking approval of their RVO structure, and any accompanying releases, should be vigilant in ensuring procedural fairness (including proper notice) and preparing a strong evidentiary record that establishes the RVO as a necessary means to achieve a proper, compelling purpose.

To discuss these issues, please contact the author(s).