

Application of Equitable Mootness in a Court Ordered Sale in Canada

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Introduction

Imagine this scenario. A receiver brings a motion to sell an operating company's assets. The second-ranking secured creditor objects to the sale. The court agrees with the receiver and grants a vesting order. The receiver has no liquidity to continue to fund the company's operations and closes the transaction later that day to maximize the value of the assets. The purchaser operates the business making daily commitments to maintain operations. A week later, the second-ranking secured creditor appeals the sale and vesting order. This scenario leaves the purchaser in a predicament. Is the appeal moot? Can the sale be reversed? Should they continue to finance the business until the issue is determined?

This scenario begs the well-known question: how do you unscramble an egg? The uncertainty in these types of scenarios could have a chilling effect on sales in court-approved processes, impacting realizations and thus returns to creditors. In the U.S., a purchaser in a Chapter 11 proceeding is protected by legislation preventing an appeals court from reversing a sale, regardless of the merits of the appeal, so long as the sale was made in good faith. Unfortunately, Canada has no similar legislation.

Therefore, in Canada, what are the options and limitations to the court officer and to the opposing party if faced with this situation?

Mootness

There are various forms of mootness. In Canada, equitable mootness is the doctrine that would be applied in this circumstance. This involves an appeal court refusing to adjudicate the findings of another court when to do so would be, *inter alia*, inequitable, particularly to innocent third parties. The doctrine fosters efficiency, promotes finality and protects parties that relied on a court order. However, the doctrine can be contentious as courts that invoke it may refuse to hear an appeal regardless of its merits.

In a sale process, the point of invoking mootness is to prevent prejudicing the rights of a good faith purchaser that is facing the prospect that a transaction can be unwound and to ensure that all parties engaged in a sale process can rely upon the certainty of the results of that process. This will encourage parties to participate in such processes and promote asset maximization. Without the ability to invoke mootness, great uncertainty would be created in the marketplace. This uncertainty would be magnified in an operating business (vs. for example, raw land real estate).

Recent Case Law

Dianor Resources Inc.

The issue of mootness was reviewed in the recent case of *Dianor Resources Inc.*ⁱⁱ Dianor was a mining company which defaulted on a loan owed to Third Eye Capital. The court appointed a receiver under the *Bankruptcy and Insolvency Act*ⁱⁱⁱ and *Courts of Justice Act*.^{iv} The receiver obtained court approval to conduct a sale process for Dianor's assets, being mining claims. Two bids were received, one being from Third Eye Capital, which was essentially a credit bid as Third Eye Capital had financed Dianor. The receiver accepted Third Eye Capital's bid which required clean title to the mining claims.

A dispute arose over whether certain royalty rights, owed to a third party, could be vested out. The sale to Third Eye Capital was eventually approved by the court and the royalty rights were vested out. The court ordered a sum of \$250,000 be paid from the purchase price to the third party based on an expert opinion of the value of the royalty rights.

The third party did not seek a stay of the vesting order while it considered whether to appeal the vesting order. The transaction closed three weeks after the court approved the transaction. Approximately a week after closing, the third party appealed the lower court's decision on whether the royalty claims could be vested out.

At the Ontario Court of Appeal, Third Eye Capital argued that, among other things, the appeal was moot because the transaction closed; the third party had ample time to seek a stay order and did not do so.

The Court of Appeal has asked for additional submissions, not related directly to the issue of mootness, before it is prepared to rule on the substantive issues of the case, but as regarding mootness it raised the issue that Third Eye Capital (having been the lender to Dianor) knew of the risks of closing. This comment by the Court of Appeal seemed to question whether Third Eye Capital was within the definition of a good faith purchaser. The Court of Appeal also questioned whether it was appropriate for the receiver to close the transaction before the expiry of the appeal period having been advised by the third party that an appeal could be launched.

Regal Constellation Hotel Ltd.

In *Dianor*, the Court of Appeal referenced an important case on the issue of mootness: *Regal Constellation Hotel Ltd.*,^v which was another decision of the Ontario Court of Appeal.

In this case, a hotel defaulted on its loan to a bank and a receiver was appointed to sell the property. After extensive marketing efforts an offer was accepted from a numbered company. A vesting order was subsequently granted by the lower court, and the transaction closed with new bank financing. After the closing, the debtor appealed the sale on the basis that the numbered company purchaser was a front for a buying group that had defaulted on a previous offer for the hotel; the accepted offer was significantly less than the defaulted offer. The shareholder of the debtor criticized the receiver for not having informed the court, at the time of the vesting order motion, who the principals were of the numbered company. The financing bank sought to quash the appeal, pleading that the appeal was moot as no stay had been sought by the appellant.

The Court of Appeal ruled the appeal was moot. It stated:

These matters ought not to be determined on the basis that the "race is to the swiftest". However, there is no automatic stay of such an order in this province [Ontario], and a losing party might be well advised to seek a stay pending appeal from the judge granting the Order....^{vi}

The Court went on to say:

Whether the provisions of s. 57 of the Land Titles Act (remedy of person wrongfully deprived of land), or the rules of professional conduct, would provide a remedy in situations where a successful party registers a vesting order immediately and in the face of knowledge that the unsuccessful party is launching an appeal and seeking a timely stay, is something that will require consideration should the occasion arise.^{vii}

Based on the above case law, in Canada, from an appellant's point of view, the chance of a successful appeal of a vesting order is improved if two key steps are taken.

The first and most important is to immediately seek a stay order.

The second step is to launch the appeal or motion for leave to appeal within the appropriate time allowed for an appeal. If neither of these actions are taken the likelihood of reversing a vesting order that approved a sale to a good faith purchaser is low.

Options for a Court Officer

What options are available to a court officer in the face of a possible appeal of a vesting order, considering its dual objectives of maximizing proceeds from the sale of assets while maintaining its duty of fairness?

If a court officer is being challenged when seeking a sale approval, it is imperative to highlight to the court that the purchaser is a good faith buyer. Absence of good faith typically involves a case of fraud, collusion between the purchaser or other bidders, or an attempt to take gross unfair advantage of other bidders.

It seems apparent that if the court officer knows that there might be an appeal of the vesting order, the court officer should not blindly close the transaction. The court officer should communicate with the possible appellant and indicate an intention to close the transaction unless the vesting order is stayed or consider waiting out the appeal period before closing. If no stay order is obtained in the proposed time frame this will put the court officer, and other stakeholders, in a much better position to show that they took all reasonable steps to ensure an objecting party had an opportunity to respond.

If there is urgency to close, for example, where the business has exhausted all its working capital and it will not be able to operate without a closing, this should be documented and, assuming a stay has not been obtained, a closing may be warranted. The court officer should make sure to document the reasons for urgency as this will assist in ensuring the decision to proceed with the closing will be supportable by available evidence. A motion for directions to the court may also be appropriate in such circumstances.

Other options available to a court officer are:

- Ask the court for an order that the appellant post a bond that can be called upon if the appellant is unsuccessful and asset values erode due to the uncertainty created or the delay in closing.
- Negotiate with stakeholders to set aside certain of the closing funds until the determination of any appeal.

Of course, both of the above alternatives are driven by factual circumstances. For example, if the appellant is challenging a credit bid there are no funds available to set aside.

The U.S. Regime

In similar situations in the U.S., stakeholders are assisted by section 363 (m) of the *United States Bankruptcy Code*, which provides for statutory mootness (vs. equitable mootness):

*The reversal or modification on appeal of an authorization under subsection (b) or (c) of this Section [which are part of any 363 (f) sale] of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, **unless such authorization and such sale or lease were stayed pending appeal.*** (Emphasis added).^{viii}

As such, in the U.S., provided there is a good faith purchaser,^{ix} the sale cannot be reversed unless it is stayed pending appeal. It should be noted that under the *United States Bankruptcy Code* there is an automatic stay of 10 days after the sale authorization although courts can be asked to waive this stay period. Generally, U.S. courts apply the concept of mootness once a sale has closed to a good faith purchaser.

Conclusion

Two of the central pillars of insolvency legislation are its finality and efficiency. Those pillars appear to be better served in the U.S. with section 363(m) of the *United States Bankruptcy Code*. While Canadian courts generally do apply mootness in the context of an appealed vesting order, it would be helpful if Canadian insolvency legislation adopted a similar rule to statutorily protect good faith purchasers. This would help to maximize the realizations for assets in an insolvency with the comfort that statutory mootness will likely apply. Without the benefit of mootness being codified into our legislation, if there is potential for a vesting order appeal, court officers should be cautious before closing a transaction.

ⁱ The author would like to thank Peter Farkas for his assistance in preparing this article.

ⁱⁱ *Third Eye Capital Corporation v. Dianor Resources Inc.*, [2008], ONCA, 253

ⁱⁱⁱ R.S.C., 1985, c. B-3.

^{iv} R.S.O. 1990, c. C.43.

^v *Regal Constellation Hotel Ltd. (Re)*, [2004], O.J. NO. 2744

^{vi} *Ibid* at para. 49.

^{vii} *Ibid*.

^{viii} 11 U.S.C. SS. 363 (m)

^{ix} As outlined in the U.S. Bankruptcy Court, Northern District of California, Guidelines re: Sales Orders, good faith determination involves a number of factors including the bidder's relationship with any other bidder or any other party related to the debtor; also the anticipated relationship of a bidder with the debtor's officers and directors or the payment of any consideration to any other party but the debtor.