Rights of First Refusal and Options to Purchase in Insolvency Proceedings – Not Quite Insurmountable

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1. INTRODUCTION

Can assets subject to a right of first refusal ("ROFR") or an option to purchase ("OTP") be conveyed pursuant to a court-approved sale process without first complying with the terms of the ROFR or OTP? Does the court have the ability to vest out ROFRs or OTPs, or suspend their application? These questions have been placed under the spotlight in recent insolvency proceedings under the *Companies' Creditors Arrangement Act*[1] such as the liquidation of the Sears Canada group of companies ("Sears") or the restructuring of Great Slave Helicopters Ltd. ("GSH"). In Sears, the company faced opposition from a pre-existing option-holder in respect of certain intellectual property of Sears; the option-holder ultimately purchased the intellectual property. In GSH, two Aboriginal joint-venture partners, Gwichin'in Development Corporation ("GDC") and Sahtu Helicopters Ltd. ("Sahtu"), opposed GSH's sale approval motion on the basis that GSH's motion ignored the ROFRs in favour of the Aboriginal groups that attached to certain joint venture agreements to be transferred. Similar to Sears, the court approved the proposed transaction but the applicant was forced to comply with the terms of GDC's and Sahtu's ROFRs.

These cases raise a series of questions, namely:

- Are ROFRs and OTPs incompatible with the objectives of restructuring processes?
- Can such provisions be avoided by arguing, for example, that an OTP impairs the realizable value of an asset in a competitive bidding process?
- Can agreements containing such clauses be disclaimed as executory contracts?

After a brief introduction to the concepts of ROFRs and OTPs, this paper will explore whether Canadian common law courts presiding over insolvency proceedings would be willing to approve the sale of ROFR

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1 R.S.C. 1985, c. C-36 [CCAA].

and OTP encumbered assets in a competitive bidding process without first complying with such restrictions, and whether courts would be willing to vest out those restrictions against such assets. This paper will also consider whether, under the common law, agreements containing ROFRs and OTPs can be disclaimed under the CCAA and identify some of the practical implications of ROFRs and OTPs in the context of an insolvency sale process.

2. ROFRs vs. OTPs

A ROFR is a contractual obligation that requires the owner of an asset to offer to sell its asset to the rights-holder after receiving a *bona fide* offer from a third party to buy such asset. ROFRs can apply to almost any type of asset, from real property to equity ownership in corporations. ROFRs often appear in shareholder agreements to ensure equity ownership remains with the incumbent shareholder group by requiring any third-party offer to purchase shares first be made to other shareholders on substantially the same terms as the third-party offer. In GSH, the shareholder agreements between GSH on one hand, and GDC and Sahtu on the other, which set out the terms on which GSH could sell its 49% interest in either of the two joint venture entities, were subject to a ROFR. ROFRs are also often seen in leases or agreements between adjacent land owners, giving a neighbour the right to purchase the adjacent property if the other neighbour decides to sell. In Sears, ROFRs (and sometimes OTPs) were found in a number of operating agreements between Sears and adjacent mall owners. At common law, ROFRs are personal contracts. Although ROFRs may be registered on title when they apply to real property, an equitable interest in the land is not created until an acceptable third-party offer is received by the party bound by the ROFR. This reasoning led the court in *Canadian Long Island Petroleums Ltd. v. Irving Wire Products*[2] to conclude that a ROFR is not a negative covenant which runs with the land.

An OTP is a right granted to the option-holder that allows, but does not require, the option-holder to complete a transaction pursuant to certain pre-determined terms. While similar to a ROFR in that the option can be granted over virtually any type of asset, an OTP, unless invalid or expired, creates a right vested in the property and is enforceable against a third-party purchaser.[3]

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2 (1974), [1975] 2 S.C.R. 715 (S.C.C.) [*Irving*]. See also *Cooper v. Wynne*, 2012 ONSC 934, 22 R.P.R. (5th) 273 (Ont. S.C.J.) at para. 20 and *Benzie v. Kunin*, 2012 ONCA 766 (Ont. C.A.).

Outside of the bankruptcy and insolvency context, the law is well established concerning the consequences of failure to comply with ROFR or OTP provisions in the sale of the underlying property. Generally, if real property is sold to a third party without observing a ROFR, specific performance is available as a remedy to the ROFR-holder, if the ROFR-holder is able to demonstrate that the property is unique. This is easier to establish in the case of real property than personal property.[4] Otherwise, the ROFR-holder is left with a claim for damages.

In *2123201 Ontario Inc. v. Israel Estate*,[5] the court summarized the legal differences between OTPs and ROFRs and held that OTPs create immediate interests in land, while ROFRs do not.[6] OTPs are specifically enforceable and subject to the rule against perpetuities, while ROFRs are not. Finally, even though not determinative, OTPs give the option-holder control over the decision to effect a conveyance. ROFRs give the land owner control over the decision to convey.[7]

In this paper, we apply the legal distinctions between ROFRs and OTPs to answer the questions: are insolvency courts willing to approve sales of assets encumbered by OTPs or ROFRs, and vest out or disclaim such covenants?

3. APPROVAL OF SALE OF PROPERTY ENCUMBERED BY ROFRS OR OTPS

(a) CCAA Proceedings

Pursuant to the CCAA, out of the ordinary course asset sales above a certain value threshold prescribed in the initial order must be approved by the court. This approval process implicitly grants rights-holders a forum to enforce the rights granted to them under ROFRs or OTPs, which they would not have outside of a CCAA process. Accordingly, a potential post-sale remedy is turned into a pre-sale opportunity for the rights-holder to make submissions to the court as an interested party.

3 *Re Dust & Blast Machine Services Ltd.* (1995), 30 C.B.R. (3d) 74 (Ont. Bktcy.) (in *obiter*) [*Dust & Blast Machine*].

4 See *Semelhago v. Paramadevan*, [1996] 2 S.C.R. 415 (S.C.C.) and, in Alberta, *1244034 Alberta Ltd. v. Walton International Group Inc.*, 2007 ABCA 372 (Alta. C.A.), leave to appeal refused 2008 CarswellAlta 615 (S.C.C.).

5 2016 ONCA 409 (Ont. C.A.) [*2123201 Ontario*].

6 Note that the British Columbia *Property Law Act*, R.S.B.C. 1996, c. 377, s. 9 provides that ROFRs over land create an equitable interest in the land. Ontario does not have similar legislation.

7 *2123201 Ontario*, *supra* note 5 at para. 23. See also *2284064 Ontario Inc. v. Shunock*, 2017 ONSC 7146 (Ont. S.C.J.).

The following discussion considers whether a rights-holder could enforce a ROFR or OTP in the context of the sale of a business as a going concern under the CCAA.

The CCAA is intended to facilitate compromises between companies and their creditors as an alternative to bankruptcy. The CCAA is often interpreted liberally, as remedial legislation that is purposely skeletal in nature to allow for the flexibility necessary to adapt to the unique attributes of specific cases.[8] Section 11 of the CCAA grants courts the right to "make any order that it considers appropriate in the circumstances" except as limited by the CCAA. As such, the CCAA court is well equipped to approve the sale of an OTP- or ROFR-encumbered asset to a party other than the rights-holder and without having first complied with the restrictive covenants if the transaction is in the best interests of the creditors at large, provided that the interest of the OTP or ROFR-holders is taken into account. The court will consider, *inter alia*, the monitor's views on these issues before making any such approvals.

Under section 36 of the CCAA, the debtor's assets cannot be sold out of the ordinary course of business unless the transaction is approved by the court. In determining whether to approve a sale, the court is required to consider, among other criteria, the effects of the proposed sale or disposition on the creditors and other interested parties. The Supreme Court of Canada emphasized this point, holding that CCAA courts must account for "various interests at stake in the reorganization ... even other parties doing business with the insolvent company".[9] The implication for a ROFR- or OTP-holder is that, unlike in court proceedings outside of the bankruptcy or insolvency processes, the CCAA court must balance the competing interests of stakeholders at large with the interests of a ROFR or OTP right-holder. In *ATB Financial v. Metcalfe & Mansfield Alternative Investments II Corp.*,[10] the Court of Appeal for Ontario dealt with this issue in the context of the restructuring of Canada's asset-backed commercial paper market following the 2008-2009 financial crisis. In that case, the court held that third-party rights may be compromised in a plan if: (1) such compromises are necessary and essential to the restructuring of the debtor; (2) the compromised rights are rationally related to the purpose of the plan and necessary for

8 *Re U.S. Steel Canada Inc.*, 2016 ONCA 662 (Ont. C.A.) at paras. 43 and 47, additional reasons 2016 CarswellOnt 16446 (Ont. C.A.), leave to appeal allowed *USW, Local 8782 v. U.S. Steel Canada Inc.*, 2017 CarswellOnt 3573 (S.C.C.).

9 *Century Services v. Canada*, 2010 SCC 60 (S.C.C.) at para. 60 [*Century Services*].

10 2008 ONCA 587 (Ont. C.A.), leave to appeal refused 2008 CarswellOnt 5432 (S.C.C.) [*Metcalfe*].

it; (3) the plan of compromise cannot succeed without compromising such rights; (4) the beneficiaries of the compromise are contributing to the plan in a tangible and realistic way; and (5) the plan will benefit not only the debtor companies but the creditors generally.[11] *Metcalfe* dealt with a compromise involving releases of claims against third-party financial institutions, which was an issue of national importance and had broad implications on the Canadian economy. As such, the test for compromise required a very high bar. A similar but maybe less onerous reasoning may be applicable to compromising the rights of third-party ROFRs or OTPs.

Indeed, some courts have found that ROFRs are not triggered by the sale of bundled assets under the CCAA. In *Re Bear Hills Pork Producers Ltd.*,[12] the applicants sought to sell a bundle of disjointed properties which were subject to several ROFRs. The Saskatchewan Court of Queen's Bench allowed the sale without first requiring the ROFRs be complied with because, among other reasons, the prospective purchaser would only consider purchasing the complete bundle of properties for an aggregate purchase price and did not allocate value on a property by property basis as the offer was not severable. The court endorsed the view that:

> [A] right of first refusal required that a *bona fide* offer for the property in question be made. Where, in that case as here, a sale of a large number of assets was contemplated there was effectively no offer for the holder of the right of first refusal to accept or to refuse.[13]

In making the decision, the court struck a balance to preserve the welfare of the business of the debtor recognizing that failure to sell the bundled properties may have resulted in a forced liquidation of the debtor's assets which could jeopardize 160 jobs.[14] The court noted that if the sale had been a single asset sale, the ROFR would have most likely been triggered.[15] The court did not address whether the ROFR provisions remained in place post-sale.

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11 *Ibid.*, at para. 71.

12 2004 SKQB 213 (Sask. Q.B.), additional reasons 2004 CarswellSask 418 (Sask. Q.B.) [*Bear Hills*].

13 *Ibid.*, at paras. 6-7, citing *Budget Car Rentals Toronto Ltd. v. Petro-Canada Inc.* (1989), 69 O.R. (2d) 289 (Ont. C.A.) and *Southland Canada Inc. v. Zarcan Equities Ltd.*, 1999 ABQB 831 (Alta. Q.B.).

14 *Ibid.*, at para. 9.

15 *Ibid.*, at para. 8.

The *Bear Hills* decision cannot be interpreted as a hard-and-fast rule. In GSH, the transaction before the court for approval was a going-concern sale for substantially all of GSH's business and assets. The purchased assets included GSH's joint venture interests pursuant to certain shareholder agreements which enabled GSH to provide helicopter services to Aboriginal groups, including GDC and Sahtu. This was a bundled asset sale, as was the case in *Bear Hills*, for which the purchaser had not yet provided a purchase price allocation. The sale approval motion was opposed by GDC and Sahtu on the basis that, *inter alia*, the proposed transaction did not respect the terms of their ROFRs. In the end, the court did not have to rule on the dispute as a consensual arrangement was negotiated in order to provide both GDC and Sahtu the opportunity to exercise their ROFRs after reviewing the attributes of the transaction and the proposed purchaser. The relevant excerpt of Justice Hainey's endorsement of November 23, 2018 is as follows:

> The court directs the purchaser to provide the Monitor and the Applicant with the purchase price allocation contemplated by the APA prior to the closing of the transaction in order for the Applicant to commence the ROFR process set forth in the Sahtu and Gwich'in Shareholder agreements.
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> Promptly following the receipt of the purchase price allocation and closing, the Monitor shall provide to counsel to each of Sahtu and Gwich'in (on a confidential basis) the following information with respect to the purchase price allocation:
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> (a) the aggregate purchase price;
> (b) the aggregate value allocated to all joint venture interests acquired by the purchaser; and
> (c) the value allocated to the Sahtu and Gwich'in joint venture interest, as applicable.
>
> Until such time as the counterparties to the Sahtu and Gwich'in ROFR provisions exercise their rights in accordance with paragraphs 8 and 9 of the Approval and Vesting Order, the purchaser shall operate the Sahtu and Gwich'in ROFR Assets in the ordinary course.[16]

The treatment of ROFRs in the GSH proceeding, and the eventual consensual resolution of the dispute, reflects the significance of the ROFR issue and the uncertainty around its treatment in the context of CCAA proceedings. Since the dispute on the treatment of ROFRs in the

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16 *Great Slave Helicopters Ltd. v. Gwichin Development Corp.* (November 23, 2018), CV-18-604434-00CL (Ont. S.C.J.) (endorsement).

GSH proceeding was resolved consensually, the case does not provide further precedential direction with respect to the ability to avoid ROFRs in the context of a bundled asset sale under the CCAA.

(b) BIA Proceedings

Although there are few cases dealing with this issue under the CCAA, there is support for the courts' willingness to balance interests of creditors with the interest of ROFR-holders in proceedings under the *Bankruptcy and Insolvency Act*.[17] In *Ford Credit Canada Ltd. v. Welcome Ford Sales Ltd.*,[18] the court sanctioned a bundled asset sale without triggering the ROFR that was attached to one of the properties. In that case, the court considered an assignment under section 84.1 of the BIA of a dealership agreement between the bankrupt and Ford which contained a ROFR in favour of Ford.[19] Ford objected to the assignment on the grounds that the dealership agreement, being integral to the healthy operations of the dealership, was a personal contract that was not capable of being assigned.[20] The court allowed the assignment but noted that it was an important factor in the court's decision to permit the assignment of a contract containing a ROFR that all of the rights and remedies of Ford, including the ROFR under the agreement, would be preserved. The court also noted that Ford failed to demonstrate that it would suffer material prejudice if it was not allowed to exercise its ROFR and terminate the dealer agreement.[21] In that case, the bundled going-concern sale of the dealership, including the dealership agreement with Ford, generated offers that would pay out the secured lender and recoveries for other creditors, while a liquidation of the assets without the dealership agreement would have resulted in a shortfall to the secured

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17 R.S.C. 1985, c. B-3 [BIA].

18 2010 ABQB 798 (Alta. Q.B.), affirmed 2011 ABCA 158 (Alta. C.A.) [*Ford Credit Canada*].

19 Section 84.1 allows a court, upon being satisfied that certain prerequisites are met, to grant an order assigning the rights and obligations of the bankrupt under any agreement to a purchaser, even without the consent of the counter-party to the agreement.

20 *Ford Credit Canada*, *supra* note 18 at para. 54. Section 84.1(3) of the BIA provides that s. 84.1 "does not apply in respect of rights and obligations that are not assignable by reason of their nature."

21 *Ford Credit Canada Ltd. v. Welcome Ford Sales Ltd.*, 2010 ABQB 199 (Alta. Q.B.) at para. 24, additional reasons 2010 CarswellAlta 2806 (Alta. Q.B.), affirmed 2011 CarswellAlta 883 (Alta. C.A.) (*Ford Credit Canada*, *supra* note 18 being additional reasons to this case).

lender and no recovery for subordinate creditors. As the court did in *Bear Hills*, the court in *Ford Credit Canada* engaged in a balancing exercise.

A different approach to deal with a ROFR was taken by the court in *Dust & Blast Machine*,[22] where a trustee sought the court's permission to sell real property of the bankrupt with leases that included either a ROFR or an OTP on the basis that the properties would generate enhanced value if marketed without such covenants. The court stated that:

> The rights and liabilities of an assignee of the lease depend on whether or not the covenant in question touches or concerns the land. While the subject is not free from difficulty . . . it would appear that . . . a right of first refusal on a sale of the leased property is a personal covenant, as between the landlord (bankrupt) and the various lessees, and accordingly a purchaser from the landlord would not be bound by that covenant.[23]

However, as to the option to purchase, the court stated: "[an] option is an interest in land which is always enforceable against the purchaser from the Landlord, and it would be quite wrong for this Court to suggest that the bankrupt could sell free and clear of that option."[24]

While the court granted permission to the trustee to market the real property without first complying with the ROFR, it refused to declare that any purchaser of the leased property from the landlord was not bound by the ROFRs on a subsequent sale of the property. The court suggested that such a declaration can only be made, if at all, when the property is sold and the purchaser moves for such a declaration. The court again tried to find a balance between maximizing the value of the estate while preserving the ROFR-holder's ability to seek an appropriate remedy.

(c) Bankruptcy proceedings in the United States

Given the scarcity of jurisprudence in Canada on this issue, it is helpful to look for guidance south of the border. The Bankruptcy courts in the United States consider ROFRs to be restrictions on assignments within the meaning of section 365(f)(1) of the *Bankruptcy Code*.[25] That section provides that a trustee may, subject to certain conditions, assign a contract or lease notwithstanding a provision in an executory contract

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22 *Supra* note 3.

23 *Ibid.*, at para. 9.

24 *Ibid.*, at para. 12.

25 11 U.S.C.

that prohibits, restricts or conditions the assignment of such contract or lease. Accordingly, courts have found that section 365(f) renders ROFRs unenforceable.[26]

In *Mr. Grocer*, in the context of the going-concern sale of a supermarket operation that included inventory, equipment, other fixtures and a ROFR-encumbered leasehold interest, the court relied on statutory interpretation principles to find that the ROFR was unenforceable because it restricted assignment. However, the court also invited counsel to make submissions concerning other grounds on which it could find that the ROFR was unenforceable in a sale or transfer of property in a bankruptcy proceeding. Both the debtor and the prospective purchasers argued that the ROFR would have a "chilling" effect on the ability of the debtor to obtain bids for the purchase of leasehold interests in bankruptcy proceedings. The court rejected as "essentially specious" the landlord's argument that the estate would not be hurt "because in no event will the estate get less than the bid price". The court in *Mr. Grocer* went on to say:

> That contention begs the question as to whether the eventual effect of enforcing first refusal rights would not discourage prospective purchasers and assignees from making the effort to initially put a bid before the bankruptcy court to be matched.
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> The landlord's glib assertion that it will "pay the same price" if it exercises its right of first refusal leaves unanswered the practical question of *what is that price* and how many more hearings would be necessary to determine the matter even *after* the court completed its evidentiary hearing on the financial status of the prospective purchasers and entered its order approving assumption and assignment of [the agreement]
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> . . . . .
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> Accordingly, if the "chilling effect" contention were material to my decision in the present case, and I had to decide it on the basis of the present record, I would conclude that enforcement of such provisions necessarily must have some chilling effect. It should also be added that the "chill" well may be intensified if prospective bidders must be advised that they not only have a duty to disclose their financial condition and assets in great detail, to satisfy the "adequate assurance" requirement, but also that the assets in question could be taken away from them even *after* a court order approving the same has been entered – not by virtue of any higher bid but simply at the same price under a first refusal right.[27] [emphasis in original]

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26 See *In re Mr. Grocer, Inc.*, 77 B.R. 349 (Bankr. D. N.H., 1987) [*Mr. Grocer*] and *In re Adelphia Communications Corp.*, 359 B.R. 65 (Bankr. S.D. N.Y., 2007) [*Adelphia*].

27 *Ibid.*, at 353-354.

In *Adelphia*, in the context of a sale of bundled franchise agreements, the U.S. Bankruptcy Court agreed that a ROFR could have a chilling effect on bids. However, this effect would not necessarily be applicable in every case. In that case, the court found that ROFRs were unenforceable because they "thwart the fundamental policy of maximizing estate assets for the benefit of all creditors".

The courts in both *Mr. Grocer* and *Adelphia* recognized that a ROFR that applies only to a subset of the assets to be sold could "be destructive to maximizing value, and have a chilling effect on future bankruptcy auctions." As the U.S. court noted in *Adelphia*, purchase price allocation can become a burdensome issue in a multi-asset sale where some of the assets are subject to ROFRs:

> The computation likely could be made, in this Court's view, but as the complexity of the transaction increases . . . the time and expense associated with making the allocation likewise increases, to a point where it gets to be a material burden.

While there are some cases in which U.S. courts have been prepared to enforce ROFRs in a bankruptcy asset sale, these cases generally involve a single asset[28] or a single ROFR.[29]

The cases from the United States are not binding on a Canadian CCAA court and the relevant criteria considered with respect to assignment under the US *Bankruptcy Code* are not the same as those generally considered by a CCAA court. Nevertheless, these cases may have some persuasive value, particularly with respect to the non-statutory grounds that these courts have considered relevant for determining whether ROFRs should be enforced on the sale of assets by a debtor under Chapter 11 proceedings. In particular, cogent evidence that a going-concern sale would generate greater recoveries than a piecemeal sale of assets may persuade a court that allowing the exercise

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28 In *Adelphia*, the court referred to some of these cases. See *In re E-Z Serve Convenience Stores, Inc.*, 289 B.R. 45 (Bankr. M.D. N.C., Div. Durham, 2003) and *In re the IT Group, Inc.*, 302 B.R. 483 (D. Del., 2003).

29 In a recent decision, the District of Delaware Bankruptcy Court overrode the objections of a real estate developer who held a right of first refusal over a single property amongst the fifty-three properties that were being sold in the debtor's bankruptcy. See *In re Fresh & Easy Neighborhood Market*, unreported Case No. 13-12569 (D. Del., December 19, 2013). Although the court initially rejected the developer's arguments, it subsequently entertained its objections when it learned that the developer had not received notice of the sale. However, based on the evidence, it overruled that objection and held that the developer had received sufficient notice of the sale but chose not to act until it was too late.

of a ROFR would thwart the policy of the CCAA to maximize value for the benefit of all creditors. Nonetheless, the U.S. jurisprudence on the ability to sidestep a ROFR in the context of a single asset or bundled asset sale has not yet been considered by Canadian courts.

(d) Summary

Based on the limited Canadian jurisprudence on the matter, and considering the non-statutory grounds recognized by US courts, it is clear that courts are willing to balance interests by trying to maximize value of the estate or successfully restructure businesses, while attempting to preserve the rights of ROFR- and OTP-holders to the extent possible. In the context of a bundled asset sale under the CCAA, it is possible to avoid a ROFR if, on balance, the ROFR-holder does not suffer material prejudice. The decision in *Dust & Blast Machine* and the non-statutory grounds for avoiding ROFRs in the U.S. make it plausible to get around a ROFR in the context of a single-asset sale under the CCAA, despite there being no known precedent. Of course, bypassing a ROFR in the single asset sale context would be more difficult as the accretive effect on value by avoiding a ROFR would arguably be lower than in the context of a bundled asset sale. Since OTPs create a real right in the asset that runs with the land, OTPs can seemingly always be enforced, although jurisprudence on this matter is limited.

4. VESTING OUT OTPS AND ROFRS

In the previous sections, we demonstrated that CCAA courts are willing to approve the marketing and sale of ROFR-encumbered assets without requiring compliance with the ROFR, at least under certain circumstances. We also argued that, based on *Dust & Blast Machine*[30] and non-statutory grounds in U.S. case law, CCAA courts might be inclined to approve the sale of a single asset encumbered by a ROFR without first offering the asset to the rights-holder. The question remains whether a CCAA court would be willing to grant an approval and vesting order conveying to a purchaser all of the right, title and interest in and to OTP- or ROFR-encumbered property free and clear of those encumbrances.

30 *Supra* note 3.

(a) Vesting out restrictive covenants

Under subsection 36(6) of the CCAA, the CCAA court is permitted to authorize a sale or disposition of an asset free and clear of any security, charge or other restriction, as long as the rights of the parties holding such rights are transferred to the proceeds of the sale or other assets of the debtor. While there is virtually no Canadian jurisprudence discussing whether courts can specifically vest out ROFRs or OTPs in the context of CCAA or BIA proceedings, there are several cases in which courts have been confronted with a request to vest out leasehold interests or other restrictive covenants.[31] These cases indicate that courts are very reluctant to vest out interests in land unless there are equitable considerations favouring the vesting out. This is particularly the case where the estate of an affected third party is separate from the debtor since the court has jurisdiction only over the estate of the debtor and not any third party.[32]

Perhaps the most illustrative example of the CCAA court's unwillingness to vest out a restrictive covenant can be found in the context of real property conveyances in *Terastar*, where Justice Hoy (as she then was) refused to grant a vesting order to convey the property free and clear of a restrictive covenant in favour of McDonald's Restaurants of Canada Limited ("McDonald's"). The restrictive covenant in favour of McDonald's was registered on title and restricted Terastar's property from being used for certain restaurant purposes without the express consent of McDonald's. None of the parties disputed the fact that the restrictive covenant was a negative covenant that ran with the land. The monitor was of the view that the offer generated under the sale process was the highest and best offer that could be obtained for the property.

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31 See *Royal On Gordon Retirement Residence Inc. v. Paterson*, 2012 ONSC 2768 (Ont. S.C.J.) [*Royal*]; *Romspen Investment Corp. v. Woods Property Development Inc.*, 2011 ONSC 3648 (Ont. S.C.J.), reversed 2011 CarswellOnt 14462 (Ont. C.A.), additional reasons 2012 CarswellOnt 2047 (Ont. C.A.); *Re 1565397 Ontario Inc.*, 2009 CarswellOnt 3614, [2009] O.J. No. 2596 (Ont. S.C.J.) [*1565397 Ontario*]; *Meridian Credit Union Ltd. v. 984 Bay Street Inc.*, 2006 CarswellOnt 4783, [2006] O.J. No. 3169 (Ont. S.C.J.); *2022177 Ontario Inc. v. Toronto Hanna Properties Ltd.*, 2005 CarswellOnt 5194, [2005] O.J. No. 4527 (Ont. C.A.) [*Toronto Hanna*]; and *Re Terastar Realty Corp.*, 2005 CarswellOnt 5985, [2005] O.J. No. 4742 (Ont. S.C.J.) [*Terastar*].

32 See, *e.g.*, *Royal*, *ibid.*, at paras. 17-18. See also the discussion in English, D Robb and Plunkett K, "'Keep Your Hands Off My Royalties!' – Exploring the Court's Power and/or Willingness to Vest Off Royalty Claims under An Approval and Vesting Order," in Janis P Sarra, ed., *Annual Review of Insolvency Law 2017* (Carswell: Toronto, 2018) at 15.

Both the monitor and Terastar's secured creditors supported the sale and argued that the court had power under the CCAA to remove a restrictive covenant as part of a sale approval and vesting order.[33]

Justice Hoy noted that she had discretionary power under section 61 of the *Conveyancing and Law of Property Act*[34] to discharge a restrictive covenant. Subsection 61(1) states:

> 61(1)Where there is annexed to land a condition or covenant that the land or a specified part of it is not to be built on or is to be or not to be used in a particular manner, or any other condition or covenant running with or capable of being legally annexed to land, any such condition or covenant may be modified or discharged by order of the [Superior Court of Justice].

Justice Hoy confirmed that the following test, set out in *Re Ontario Lime Co.*,[35] was to be applied in determining whether she could remove the restrictive covenant under section 61 of the CLPA:

> ... The Court should not sanction the making of an order which would substantially depreciate the adjacent land. It has been more than once pointed out that under this statute there is no power to make compensation to a land owner who is prejudicially affected, and that jurisdiction is one to be exercised with the greatest caution, and an order should seldom, if ever be made which will in truth operate to the prejudice of the adjacent landowner who has any real rights. The true function of the statute is to enable the Court to get rid of the condition or restriction which is spent or so unsuitable as to be of no value and under circumstances when its assertion would be clearly vexatious.[36]

Justice Hoy then considered the cases cited by the parties in support of vesting out the restrictive covenant[37] that suggested that the court had the power under the CCAA to remove a restrictive covenant as part of a sale approval and vesting order. After reviewing and distinguishing most of the cases, Justice Hoy declined to exercise her discretion to grant the vesting order to discharge the restrictive covenant in favour of

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33 *Terastar*, *supra* note 31 at para. 13.

34 R.S.O. 1990, c. C.34, s. 61(1) [CLPA].

35 (1926), 59 O.L.R. 646 (Ont C.A.).

36 *Terastar*, *supra* note 31 at para. 18.

37 Amongst other cases which she distinguished, Justice Hoy reviewed the decision of the Court of Appeal in *Toronto Hanna*, *supra* note 31. She also disregarded *Re Philip Analytical Services Inc.*, 2005 CarswellOnt 2988, [2005] O.J. No. 2915 (Ont. S.C.J. [Commercial List]) which considered the effect of a vesting order on certain positive covenants relating to land but was decided before the Court of Appeal's decision in *Toronto Hanna*.

McDonald's. She noted that there was a difference between discharging a covenant running with the land (where the court must proceed with caution before affecting an adjacent owner's rights) and terminating an executory contract (which at the time was commonplace but not yet expressly sanctioned by the CCAA). She also noted that there is a difference between a going concern restructuring and a CCAA liquidation proceeding. In the former, the restructuring of the debtor is paramount and, in those circumstances, it is important to obtain the highest and best price for the property. Justice Hoy also indicated that the court had no evidence that the purchaser was unwilling to purchase the property at a reduced price with the restrictive covenant remaining in place. She also expressed concern that there was no evidence of failed or unreasonable negotiations between the purchaser and McDonald's concerning the terms on which the restrictive covenant could be deleted. Nor was there evidence before Justice Hoy that the purchaser sought an abatement of the purchase price in an amount equal to an amount that could be paid to McDonald's for removal of the covenant.[38]

Justice Hoy found guidance in Justice Cronk's decision in *Toronto Hanna*.[39] In that case, the Court of Appeal for Ontario concluded that CCAA vesting orders granted in the CCAA proceedings of 360 Group did not affect Toronto Hanna's interest under a density agreement that was an "independent contractual right in the nature of a restriction on the permitted future use of designated lands". Notice of the density agreement was registered on title. The purchaser was of the view that it took the lands free and clear of the density agreement. The court did not agree and concluded that the vesting order did not affect Toronto Hanna's interests under the density agreement.

Critically, Justice Cronk in *Toronto Hanna* noted that while 360 Group could dispose of its right, title and interest in the property, it could dispose of no more than it held. A CCAA vesting order could not purport to vest in the purchaser assets in which the 360 Group had no interest and was in no legal position to convey. Further, Justice Cronk stated that Toronto Hanna had no recourse to make a claim for compensation in the CCAA proceedings as it was not a creditor or a party to the CCAA proceedings. Finally, Justice Cronk added that CCAA orders do not have the effect of eliminating substantive rights of persons who did not have notice that their interest could be potentially affected by the CCAA proceedings: "CCAA proceedings do not license the permanent abrogation of substantive contractual rights or property

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38 *Terastar*, *supra* note 31 at para. 46.

39 *Supra* note 31.

interests of strangers to the proceedings without notice or compensation."[40]

In subsequent cases, courts have considered whether the equities favour a vesting order in these circumstances. In *1565397 Ontario*,[41] the court concluded that a receiver could not disclaim an undertaking which the court determined was an interest in land. Nor could the court authorize the receiver to vest out the undertaking. As the receiver took control only of the debtor's property, it did not have possession of, or any interest in, the respondent's property. Accordingly, the receiver had no authority under the receivership order to sell the interests of the respondents and the court did not have any authority to grant such an order in the absence of the appointment of a receiver over the respondent's property. Notwithstanding these conclusions, the court went on to consider whether the equities favoured the vesting out. Having done so, it still declined to order the vesting out. Among the relevant equities, the court considered whether: (1) the interest in the land was valuable and was not a "mere contractual interest" that could be terminated in respect of future obligations; (2) interest-holders had fully performed the obligations that were conditions to the creation of their rights; and (3) appropriate notice was given to the rights-holders and the lender had been aware of the undertaking from their initial involvement in the property.[42]

(b) Vesting out OTPs

While jurisprudence on this matter is not conclusive, it appears that a CCAA court would likely only vest out a valid and unexpired OTP that runs with the land in exceptional circumstances such as in the context of a going-concern restructuring where obtaining the highest possible price for the encumbered asset is paramount to support the restructuring efforts of the debtor company, and where the OTP rights-holders are also creditors in the proceeding and could seek compensation for any loss incurred due to the removal of the OTP right.

(c) Vesting out ROFRs

With regard to ROFRs, the answer is less straightforward. As discussed above, ROFRs are personal contracts which do not

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40 *Ibid.*, at para. 56.

41 *Supra* note 31.

42 *Ibid.* at paras. 80-84.

immediately create an equitable interest, and do not constitute negative covenants that run with the lands. ROFRs are only converted into an equitable interest in the land when an acceptable offer is received by the party who is bound by the ROFR.[43] Thus, when a CCAA court is considering whether to grant an approval and vesting order to sanction an asset sale, the personal right initially created by the ROFR is converted into a real right since an offer to purchase was necessarily made. As such, attempting to vest out a ROFR could face the same difficulty as attempting to vest out an OTP.

Nonetheless, the reasoning in *Dust & Blast Machine* (a BIA case) makes such a prospect appear plausible:

> I said that any purchaser of the leased property from the Landlord is not bound by the covenants giving the Lessees rights of first refusal because the covenants do not give rise to an interest in land and accordingly do not run with the land. But the law changes and courts have different opinions. That kind of declaration can only be made, if at all, when the property is sold and the purchaser moves for such a declaration....In addition, such a determination would take away the Lessees' injunctive rights or their remedy in law for damages for breach of the covenant granting a right of first refusal....The covenants of rights of first refusal are, in any event, probably not enforceable against any purchaser of the reversion, but this court cannot make that determination at this point on the application of the Trustee.[44]

Quebec courts have vested out OTPs and ROFRs. However, the Quebec courts' reasoning is grounded in the interpretation of rights created by such covenants under the *Civil Code of Québec*,[45] which differ from those applicable in Canadian common law provinces and are beyond the scope of this paper.[46] There is at least one example of a common law CCAA court having granted vesting orders. In *Re Arctic Glacier Income Fund*,[47] the court vested out both OTPs and ROFRs without providing any reasoning.[48] Ultimately, this decision, while indicative of the possibility of vesting out such covenants, provides little support to the analysis, as it was uncontested. In summary, common law

43 See *Irving*, *supra* note 2. See also *Cooper v. Wynne*, *supra* note 2 at para. 20.

44 *Supra* note 3 at paras. 10, 11 and 13.

45 S.Q. 1991, c. 64.

46 See, for example, *Re Aveos Fleet Performance Inc./Aveos performance aéronautique inc.*, 2012 QCCS 4074 (C.S. Que.).

47 [2012] M.J. No. 451 (Man. Q.B.).

48 *Ibid.*

CCAA courts may vest out valid or unexpired ROFRs and OTPs in a case where the equities favour such an order or on consent.

5. DISCLAIMING OTPS AND ROFRS

So far in this paper we have outlined that CCAA courts have shown some willingness to approve sales of OTP- and ROFR-encumbered assets without first complying with these covenants but vesting out such covenants may only be possible in limited circumstances. However, whether the debtor in CCAA proceedings could remove OTPs and ROFRs altogether instead of attempting to deal with them at the time of selling encumbered assets remains to be seen. Under section 32 of the CCAA, a debtor company may disclaim or resiliate any executory contract to which it is party in certain circumstances, provided that the proposed disclaimer is approved by the Monitor.[49] If the Monitor does not approve the proposed disclaimer, the debtor may apply to the court for an order that the agreement be disclaimed or resiliated.[50] The counterparty will have 15 days to make an application to the court opposing the disclaimer.[51] In deciding whether to make the order, the court considers, among other things, whether the Monitor approved the proposed disclaimer or resiliation; whether it would enhance the prospects of a viable compromise or arrangement; and whether the disclaimer or resiliation would likely cause significant financial hardship to a party to the agreement.[52]

(a) Are ROFRs and OTPs executory contracts?

OTPs and ROFRs cannot be disclaimed in accordance with section 32 if they are not executory contracts. When considering the definition of an "executory contract" in the context of bankruptcy proceedings, the court in *677960 Alberta Ltd. v. Petrokazakhstan Inc.*[53] points to Janis Sarra's statement that "generally contracts under which both parties still have obligations to perform, such that the failure to perform the contract is likely to cause a material breach that excuses the performance of the

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49 CCAA, s. 32(1). See also *Re League Assets Corp.*, 2016 BCSC 2262 (B.C. S.C.) at para. 21. Subsection 32(9) of the CCAA prohibits the disclaimer of eligible financial contracts, collective agreements, financing agreements if the company is the borrower, and leases of real property or of an immovable if the company is the lessor.

50 CCAA, ss. 32(1) and 32(3).

51 *Ibid.*, s. 32(2).

52 *Ibid.*, s. 32(4).

53 2009 ABQB 50 (Alta. Q.B.) [*677960 Alberta*].

her party".[54] Sarra draws on the U.S. bankruptcy law definition ferred to in the Insolvency Institute of Canada's Joint Task Force on isiness Insolvency Law Reform Report:

> What is an executory contract? Neither the CCAA nor the BIA use the expression, but the United States Bankruptcy Code does in s. 365 ("Code, s. 365"). In general contract law, "executory contract" means a contract under which one or both parties still have obligations to perform. However, in U.S. bankruptcy law the expression is normally given a narrower meaning. According to the most widely accepted definition in the United States, an executory contract for the purposes of Code s. 365 is:
>
> > a contract under which both the obligations of the bankrupt ["A"] under the contract and the other party to the contract ["B"] are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.
>
> (Countryman, "Executory Contracts in Bankruptcy" (1974) 57 Minnesota Law Review 439 (Part 1), at 460).[55]

On this basis, the court in *677960 Alberta* concluded that: "the term xecutory contract' . . . refers to a contract under which both parties have itstanding performance obligations."[56]

Strictly speaking, an OTP grants the option-holder a unilateral right purchase the asset and thus would fall outside of the definition of an executory contract" in the context of the CCAA. However, an OTP ten must be triggered by an event such as the passage of time or an tion by the option grantor, such as defaulting on its obligations. In ich a case, an OTP contract would impose outstanding obligations on oth parties and could qualify as an executory contract. At the very least, e court in *Emslie v. HOJ National Leasing/Ancona Inc.* opens up the ossibility of an OTP contract qualifying as an executory contract in ating that "[t]he option [to purchase] may well be an executory ontract".[57] Unfortunately, beyond entertaining the possibility of an TP agreement being an executory contract, there is no Canadian ecision that provides further clarity in this matter. While so far not

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Janis Sarra, *Rescue! The Companies' Creditors Arrangement Act* (Thompson Carswell, Toronto, 2007) at p. 178.

Report of the Insolvency Institute of Canada and the Canadian Association of Insolvency and Restructuring Professional Joint Task Force on Business Insolvency Law Reform (2002) ["Joint Task Force Report"].

677960 Alberta, *supra* note 53 at para. 46.

Emslie v. HOJ National Leasing/Ancona Inc., 2000 CarswellOnt 154 (Ont. S.C.J.) at para. 36.

considered in Canadian courts, this question has been dealt with in the U.S. with varying results.

U.S. bankruptcy courts have generally applied Countryman's definition of "executory contract", which is considerably broader in comparison with the definition adopted in the CCAA of *677960 Alberta*. The Countryman definition provides that when the option-holder does not commit a breach of the OTP agreement by resting idle or when one party to the OTP agreement only has to collect money or perform ministerial duties, then the agreement is not executory.[58] Nonetheless, at least some U.S. courts have viewed contingent obligations, such as potential indemnities, as sufficient to render the underlying OTP agreement executory as long as the trigger can occur after the bankruptcy filing.[59]

Some U.S. courts attempt to use a more flexible approach to determining whether a contract is executory and assess whether assumption or rejection of the underlying contract would have value to the estate of the bankrupt.[60] There are also examples of U.S. courts using a mixed approach between the more flexible or purposeful definition and the Countryman definition of executory contracts. For example, in *Re Roomstore Inc.*,[61] the court decided that an OTP attached to a buy-sell agreement triggering a 180-day option to purchase if either party filed for bankruptcy was an executory contract. In making its decision, the court primarily relied on the fact that negative covenants requiring all parties to refrain from transferring or encumbering their interest in the debtor were considered contingent obligations imposed on both parties. Consequently, the court held that the OTP agreement would be an executory contract in accordance with the Countryman definition:

> . . . the court here is evaluating a complex contract with multiple continuing conditions. . . in light of the continuing obligations on each side and the binding Fourth Circuit precedent of Lubrizol, I find the Buy-Sell Agreement to be an executory contract.[62]

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58 *Re Robert L. Helms & Dev. Co., Inc.*, 139 F.3d 702 (9th Cir., 1998) at 707 [*Helms*]; *BNY, Capital Funding LLC v. US Airways, Inc.*, 345 B.R. 549 (E.D. Va., Div. Alexandria, 2006) at 555; *Re Kmart Corp.*, 290 B.R. 614 (Bankr. N.D. Ill., Div. Eastern, 2003) at 617.

59 *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2D 1043 (4th Cir., 1985) at 1046; *Re Safety-Kleen Corp.*, 410 B.R. 164 (Bankr. D. Del., 2009) at 167.

60 See, *e.g.*, *Helms*, *supra* note 58 at 706.

61 473 B.R. 107 (Bankr. E.D. Va., 2012).

62 *Ibid.*, at 114-115.

The court also noted that failure to reject the OTP agreement would likely lead to the sale of property under fair market value and thus, the value of the estate would not be maximised.[63]

In summary, the determination of whether an OTP contract is executory is fact-specific and largely depends on the contingent obligations, if any, that remain after the bankruptcy filing is made. Based on the definition of "executory contract" in *677960 Alberta*, which is narrower than the Countryman definition, even immaterial contingent obligations may fulfill the threshold of "outstanding performance obligations." While the definition certainly requires further probing by Canadian courts, it appears reasonable that, at the very least, OTP contracts that do not levy any obligation on the grantor, are not executory. Such a determination furthers certainty of contract. While a CCAA court necessarily will engage in a balancing act between the OTP-holder and the creditors, it would be a reasonable argument to make that an OTP-holder should not be stripped of a unilateral option to purchase an asset.

Even if a court concluded that an OTP is an executory contract, adopting the reasoning from U.S. case law, there still remains the hurdle of an OTP creating an immediate real right in the property that runs with the land, as discussed earlier. Section 32 of the CCAA creates a mechanism for disclaiming executory contracts but the *in rem* right in the asset created through an OTP is no longer a contract and, as such, section 32 should not apply. The jurisprudence on this aspect under the CCAA is not developed, but this could be a reasonable argument against the ability to disclaim OTPs.

The intent to disclaim a ROFR does not run into the same problem, since ROFRs have been held to create an immediate personal right that is only converted into a real right once a *bona fide* offer for the underlying asset is made. To the extent that the debtor wants to disclaim the ROFR prior to commencing a sale process, a real right caveat should not stand in its way.

Similarly, whether a ROFR is an executory contract appears to be less controversial than it is for an OTP. As discussed above, the court in *677960 Alberta* determined that, at least in the context of CCAA proceedings, an executory contract is "a contract under which both parties have outstanding performance obligations."[64] Under a ROFR, the rights grantor typically has the obligation to notify the rights-holder of a third-party offer and the rights-holder then has the option to either

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63 *Ibid.*, at 115.

64 *Supra* note 53 at para. 46.

give notice to the rights grantor within a prescribed time that it intends to exercise its ROFR or withhold its rights under such ROFR. In other words, both parties have outstanding obligations under a standard ROFR provision and, as such, a ROFR should be treated as an executory contract.

Unfortunately, there is very little Canadian jurisprudence on point. The matter is only discussed in one Canadian case dating back to 1978 and is outside the bankruptcy context. The court there evaluated the nature and application of an OTP and, when trying to distinguish an executory contract from an OTP, stated that ROFRs are executory contracts, agreeing with the logic above:

> An option must be distinguished *from a conditional contract which is an executory contract*, the performance of which depends upon a condition. . . . I have concluded, therefore, that Castri *describes as a conditional contract or, perhaps more specifically, to give Smiberts a right of first refusal* should they, the optionors, decide to sell.[65] [emphasis added]

Further support for the determination that ROFRs are executory in nature and as such are capable of disclaimer under section 32 of the CCAA can be found in U.S. jurisprudence. In *Re CB Holding Corp.*,[66] the court found that a ROFR is an executory contract subject to rejection under the *Bankruptcy Code* and criticized the decision *In Re Bergt*[67] which held to the contrary. The court noted that numerous other U.S. courts have determined that contingent option agreements, such as ROFRs, are executory when material obligations will arise on each side if the option is exercised.[68]

Given the support from U.S. case law, even though not definitive, the Canadian decision in *Smibert*, as well as the fact that a ROFR imposes outstanding performance obligations on both parties, ROFRs are arguably executory contracts. This conclusion is also supported by Justice Hainey's endorsement in *Re Sears Canada Inc.*,[69] where Justice Hainey did not find it necessary to address the question of whether a ROFR is an executory contract when he determined that Sears Canada was obligated to honour Middleby Corporation's ROFR on certain

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65 *Re Smibert and Shore*, 1978 CarswellOnt 3173 (Ont. C.A.) at paras. 28 and 29 [*Smibert*].

66 448 B.R. 684 (Bankr. D. Del., 2011) at 689.

67 241 B.R. 17 (Bankr. D. Alaska, 1999) at 36.

68 *Ibid.* See also *Re Kellerstrom Indus., Inc.*, 286 B.R. 833 (Bankr. D. Del., 2002) at 834-835; *Re Coordinated Financial Planning Corp.*, 65 B.R. 711 (BAP 9th Cir., 1986) at 713; *Re Hardie*, 100 B.R. 284 (Bankr. E.D. N.C., 1989) at 287.

69 2017 ONSC 7038 (Ont. S.C.J.) at paras. 22 and 23 [*Sears*].

trademarks. Rather, Justice Hainey presumed a ROFR to be of executory nature and determined the validity of the disclaimer of the ROFR based on the test under subsection 32(4) of the CCAA.

(b) Disclaiming ROFRs and OTPs under Subsection 32(4) of the CCAA

The ability to disclaim an agreement pursuant to subsection 32(1) of the CCAA is subject to the court's supervision. Subsection 32(4) of the CCAA sets out the following non-exhaustive factors the court must consider in determining whether an executory contract can be disclaimed:

> (4) In deciding whether to make the order, the court is to consider, among other things,
>
> (a) whether the monitor approved the proposed disclaimer or resiliation;
>
> (b) whether the disclaimer or resiliation would enhance the prospects of a viable compromise or arrangement being made in respect of the company; and
>
> (c) whether the disclaimer or resiliation would likely cause significant financial hardship to a party to the agreement.

The approval of the Monitor will generally have been granted at the stage of court approval of a proposed disclaimer of a ROFR or an OTP. Thus, the validity of such disclaimer will hinge on whether the disclaimer would enhance the prospects of a viable compromise and whether the disclaimer would cause significant financial hardship to a party to the disclaimed agreement.

A debtor might wish to disclaim a ROFR or an OTP because such covenants arguably impair the value of the underlying asset. It is important that the disclaimer of such covenants actually does increase the value of the estate. For example, in *Sears*, Justice Hainey held that the disclaimer of Middleby Corporation's ROFR did not maximize the value of the estate since such ROFR allowed Middleby Corporation to purchase the underlying assets "upon the same terms and conditions" as the asset purchase agreement for the trademarks.[70] As such, the ROFR would have generated the same value to the estate while being prejudicial to Middleby Corporation. Therefore, the disclaimer was not valid.

Since ROFRs generally grant the right-holder a right to match, it may be easier to disclaim the covenant prior to launching a sale process for the asset. Marketing an unencumbered asset is likely to enhance value rather than attempting to sell an asset knowing that it may be snapped up

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70 *Ibid.*, at para. 25.

by the ROFR-holder at the very end of the process. It is also likely to generate more interest and activity in the sale process, which will provide the court with comfort that the market was sufficiently canvassed. A CCAA court may be persuaded to permit the disclaimer where there is a prospect of generating higher value for the asset(s) in question.

The disclaimer of a ROFR or an OTP also faces the hurdle that it would likely cause significant financial hardship to a party to the agreement. This question is very fact-specific and must be assessed on a case by case basis. For example, in *Sears*, Justice Hainey accepted Middleby Corporation's argument that the disclaimer of the ROFR would cause Middleby significant financial hardship by: i) having to incur expenses of pursuing separate brand strategies between the Canadian market and other international markets; and ii) the inability to consolidate and protect goodwill for its "Viking" products.[71]

The section 32 analysis is driven by the facts of each case. Even though the case law on disclaiming ROFRs or OTPs under section 32 of the CCAA is very limited, it appears that ROFRs (and possibly OTPs to the extent considered executory in nature) can be disclaimed if the factual circumstances are such that the test in subsection 32(4) of the CCAA can be met.

There are other hurdles to disclaim ROFRs and OTPs under section 32 of the CCAA. For example, ROFRs may not be separable from the underlying agreement and thus the entire agreement would have to be disclaimed. If such agreement is exempt from disclaimer under subsection 32(9)[72] of the CCAA, such as an eligible financial contract, a collective agreement, a financing agreement or a lease if the debtor is the lessor, the ROFR may not be capable of disclaimer since it would be part of, and inseparable from, a disclaimer-exempt agreement. However, such exceptions do not change the fundamental analysis necessary to disclaim ROFRs and OTPs conducted herein.

6. POTENTIAL SALE PROCESS IMPLICATION OF ROFRS AND OTPS

It is well established convention in both Canadian and U.S. insolvency proceedings that a party willing to incur the time and expense to perform the level of diligence required to submit an unconditional "stalking horse" offer prior to the commencement of a sale process should be entitled to bid protections. Those bid protections

71 *Ibid.*, at para. 26.
72 CCAA, s. 32(9).

typically include a "break fee" and "expense reimbursement" mechanism. The overriding rationale for these types of bid protections is to compensate the stalking horse bidder for its substantial time and expense to the extent it is ultimately not the successful bidder at the conclusion of the sale process.

The presence of a ROFR or OTP in material contracts or property of the debtor in a CCAA proceeding may deter prospective purchasers from participating in a sale process such that bid protections are required at the outset to incentivize parties to participate in a sale process, perform diligence and submit offers. In the liquidation of Sears Canada, the monitor supported break fees proposed by prospective buyers, in cases where there was a possibility that a right-holder may exercise its ROFR.[73] Nevertheless, a break fee or similar bid protections for bidders on ROFR or OTP encumbered assets approved at the stage of approval by the court of a sale and investor solicitation process in insolvency proceedings is unprecedented.

It appears reasonable that the winning bidder would at least be reimbursed for its costs should it perform significant diligence and submit an offer only to have the ROFR-holder exercise its ROFR and acquire the asset at the conclusion of the sale process. While one could argue that this risk would be considered and priced into the purchase price, there is substantial risk of it deterring prospective purchasers from investing the time and resources to perform diligence, which would result in a less competitive sale process. Absent some form of bid protections in the appropriate circumstances, it is reasonable to conclude that a ROFR or OTP could result in an inactive or dormant sale process, whereby prospective purchasers are unwilling to incur the time and expense to "roll up their sleeves" and, accordingly, pass on an acquisition opportunity that they would otherwise pursue if the assets were not subject to a ROFR or OTP.

7. CONCLUSION

The major legal difference between ROFRs and OTPs is that OTPs create a real right in the underlying asset at inception and that such right runs with the land, while ROFRs are merely a personal right that is converted into a real right after receiving a *bona fide* offer from a third

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73 See, *e.g.*, Sixth Supplement to the Nineteenth Report of the Monitor in the proceedings of *Sears Canada Inc. et al.* (November 14, 2018), CV-18-604434-00CL (Ont. S.C.J.) at paras. 32-40; Third Sixth Supplement to the Nineteenth Report of the Monitor in the proceedings of *Sears Canada Inc. et al.* (November 14, 2018), CV-18-604434-00CL (Ont. S.C.J.) at paras. 18-21.

party to buy the ROFR-encumbered asset. With this distinction in mind, we analyzed the treatment of ROFRs and OTPs in the context of CCAA proceedings. In particular, we investigated whether Canadian common law CCAA courts would be willing to approve the sale of ROFR and OTP encumbered assets in a competitive bidding process, and if so, whether courts would be willing to vest out ROFR and OTP clauses. In the alternative, we analyzed whether ROFRs and OTPs could be disclaimed under section 32 of the CCAA. The answer to all three questions is affirmative, albeit not without major caveats. Upon review of Canadian and U.S. jurisprudence, we determined that CCAA courts, at least in the context of bundled asset sales, seem willing to approve sales of ROFR encumbered assets if, on balance, the ROFR-holder does not suffer material prejudice. On the other hand, since OTPs create a real right in the asset that runs with the land, valid and unexpired OTPs can seemingly always be enforced, although jurisprudence on this issue is limited. It also appears possible but very unlikely that CCAA courts would vest out ROFRs and OTPs at the sale approval hearing. The decision in *Dust & Blast Machine* under the BIA provides a roadmap for such a vesting order and it remains to be seen whether CCAA courts will follow suit. Lastly, it is possible to disclaim ROFRs under article 32 of the CCAA as long as the disclaimer would not cause the rights-holder to suffer financial hardship and the disclaimer would enhance the prospects of a viable compromise between the creditors and the debtor company. Having these ROFR/OTP questions unanswered at the outset of a sale process will create uncertainty and could have significant implications on an insolvency sale process. In a situation where a ROFR or OTP is so material that it may significantly impair the results of a sale process, bid protections may be warranted and incorporated into a sale process in an effort to enhance sale process activity and the value ultimately generated by the sale process.