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Vesting Off Interests in Land – The Latest Dianor Decision

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Decision Commented On: *Third Eye Capital Corporation v Ressources Dianor Inc./Dianor Resources Inc.*, 2019 ONCA 508 (CanLII)

The Ontario Court of Appeal has released its much anticipated second decision in *Third Eye Capital Corporation v Ressources Dianor Inc./Dianor Resources Inc.* (*Dianor* 2019). The issue squarely before the Court in this case was whether a vesting order granted in a receivership proceeding could extinguish a third party's interest in land in the nature of a gross overriding royalty (GOR). The Court concluded that it had the jurisdiction to do so. This appears to be the first case in Canada to reach this conclusion in the context of a GOR.

Background and Prior Decisions

Before reviewing the Court's analysis and findings, it is prudent to review the facts of this case as well as the prior *Dianor* decisions. In 2015, a receiver was appointed over the assets of Dianor, an insolvent exploration company focused on the acquisition and exploitation of mining properties in Canada. Dianor's main asset was a group of mining claims located in Ontario and Quebec. In acquiring certain mining claims in relation to its flagship project, Dianor agreed to the reservation and payment of certain GORs for diamonds and other metals and minerals in favour of 2350614 Ontario Inc. (235 Co.). After conducting a sales process, the receiver brought an application to the Court for approval of the sale of Dianor's Ontario assets to Third Eye Capital Corporation (Third Eye) and a vesting order extinguishing the GORs. The sale agreement with Third Eye contained a condition that the GORs in favour of 235 Co. be either terminated or reduced, with a cash payment of $250,000 to be paid as "fair and reasonable compensation" for the GORs. 235 Co. did not oppose the sale to Third Eye, but argued that the property was to be vested in Third Eye subject to its GORs. The motion judge (*Third Eye Capital Corp. v Dianor Resources Inc.*, 2016 ONSC 6086 (*Dianor* SCJ)) found that the GORs did not amount to interests in land and held that he had jurisdiction under the *Bankruptcy and Insolvency Act*, RSC 1985, c. B-3 (*BIA*) and *Courts of Justice Act*, RSO 1990, c. C. 43 (*CJA*) to order the property sold and on what terms. Notwithstanding his finding that the GORs did not amount to an interest in land, the motion judge went on to state: "I see no reason in logic however why the jurisdiction would not be the same whether the royalty rights were or were not an interest in land" (*Dianor* SCJ at para 40).

On appeal by 235 Co., the Ontario Court of Appeal disagreed with the motion judge's determination that the GORs did not amount to interest in land, relying on the two-part test established by the Supreme Court of Canada in the seminal *Dynex* decision (*Bank of Montreal v Dynex Petroleum Ltd.*, 2002 SCC 7; *Third Eye Capital Corporation v Ressources Dianor Inc.*, 2018 ONCA 253 (*Dianor* 2018)). Among other legal errors, that Court concluded that the motion judge failed to examine the intentions of the parties as revealed in the royalty agreements as a whole, along with the surrounding circumstances (*Dianor* 2018 at para 66). ABlawg's post on

this earlier decision is here. After concluding that the GORs were, in fact, an interest in land, the Court of Appeal then requested further submissions and argument from the parties on whether and under what circumstances and limitations a Superior Court judge has jurisdiction to extinguish a third party's interest in land, using a vesting order under s 100 of the *CJA* and s 243 of the *BIA*.

The "Vesting Issue" – The Ontario Court of Appeal's Second Decision

After a lengthy and comprehensive review of the insolvency process generally, as well as the relevant provisions of the *BIA* and *CJA*, the Court considered the scope of the approval and vesting order (which we note had been registered on title following the motion judge's decision) and whether 235 Co.'s GORs should have been extinguished from title. After reviewing case law touching on the scope of vesting orders *vis-à-vis* third party interests, the Court remarked that there did not appear to be "a consistently applied framework of analysis to determine whether a vesting order extinguishing interests ought to be granted" (*Dianor* 2019 at para 101). The Court also noted that outcomes in these cases have been determined by the particular circumstances of each case, accounting for certain factors such as the nature of the property interests, the dealings between the parties and the relative priority of the competing interests. The Court then went on to set out a framework for analysis to determine if a third party interest should in fact be extinguished, adopting a "rigorous cascade analysis" (at para 102). The Court set out a two-factor framework for considering whether an interest in land should be extinguished:

> 1. consideration of the nature of the particular interest in land; and
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> 2. whether the interest holder has consented to the vesting out of their interest either in the insolvency process itself or in agreements reached prior to the insolvency. (at para 109)

On the first part of the inquiry, the Court concluded that the key consideration was "whether the interest in land is more akin to a fixed monetary interest that is attached to real or personal property subject to the sale (such as a mortgage or a lien for municipal taxes), or whether the interest is more akin to a fee simple that is in substance an ownership interest in some ascertainable feature of the property itself" (at para 105). For the latter, the reasonable expectation of the owner of such an interest would be that its interest was of a continuing nature, and, absent consent, could not be involuntarily extinguished in the ordinary course through a payment in lieu thereof (at para 105).

The second part of the inquiry considers whether the parties have consented to the vesting off of the interest either at the time of sale or through a prior agreement. The Court noted that the more complex question arises when consent is given through a prior agreement, such as where a third party has subordinated its interest contractually (at para 107). On this point the Court reviewed an earlier Ontario decision, *R. Meridian, Ronspen, and Firm Capital Mortgage Funds Inc. v 2012241 Ontario Ltd.* (2012 ONSC 4816), where the court considered whether it was appropriate to grant a vesting order where a third party had subordinated its interest to the interest of the secured creditor. The Court noted that the priority of interests reflected in freely negotiated agreements is an important factor to consider in the analysis of whether an interest in land is capable of being vested out. Specifically, "[s]uch an approach ensures that the express

intention of the parties is given sufficient weight and allows parties to contractually negotiate and prioritize their interests in the event of an insolvency" (*Dianor* 2019 at para 108).

The Court went on to state that if the above factors from the two-part framework proved to be "ambiguous or inconclusive", a court may then engage in a consideration of the equities to determine if a vesting order is appropriate in the particular circumstances of the case (at para 110). This equitable consideration would include the prejudice, if any, to the third party interest holder; whether the third party may be adequately compensated for its interest from the proceeds of the disposition or sale; whether based on evidence of value, there is any equity in the property; and whether the parties are acting in good faith. The Court expressed that this is not an exhaustive list and that there could be other factors to consider.

In the end, the Court of Appeal held that while the GORs in this case could not be said to be a fee simple interest, they were certainly more than a fixed monetary interest that attached to the property and did not exist simply to secure a fixed finite monetary obligation. 235 Co.'s GORs were in substance an interest in a continuing and an inherent feature of the property itself (at para 111). Specifically, the Court stated that:

> […] While the GOR, like a fee simple interest, may be capable of being valued at some point in time, this does not transform the substance of the interest in to one that is concerned with a fixed monetary sum rather than an element of the property itself. The interest represented by the GOR is an ownership in the product of the mining claim, either payable by a share of the physical product or a share of revenues. In other words, the GOR carves out an overriding entitlement to an amount of the property interest held by the owner of the mining claims. (at para 113)

The Court found that given the nature of 235 Co.'s interest, and the absence of any agreement that allowed for any competing priority, there was no need to resort to a consideration of the equities, and the matter was disposed of under the aforementioned two-part framework. Despite the receiver's submission that the realities of commerce and business efficacy in this case were that the mining claims would be unsaleable without impairment of the GORs, the Court acknowledged "[t]hat may be, but the imperatives of the mining claim owner should not necessarily trump the interest of the owners of the GORs" (at para 114).

However, the practical outcome of the case was governed by the procedural issue before the Court, namely, whether or not the appeal period in the *BIA* or the *CJA* governed the appeal from the orders of the motion judge in this case. On that matter, the Court held that the appeal period was 10 days as prescribed by r. 31 of the *BIA* rules, and ran from the date of the motion judge's decision. Accordingly, 235 Co.'s appeal was out of time and the appeal was dismissed. The Court decided it would not exercise its discretion to grant any remedy to 235 Co. under any other statutory provision and that 235 Co. was entitled to the $250,000 payment it had already received and its counsel was holding in escrow.

Implications of the Decision

While at first blush, the Court of Appeal appears to have widened the door for a court's authority to extinguish a third party interest using a vesting order in insolvency proceedings, from a practical point of view, it seems unlikely that many 'typical' GORs in the oil and gas context can be extinguished based on the framework and considerations developed by the Court. The Court acknowledged that where it is an element of the property itself, a GOR cannot be reduced to an interest concerned with a fixed monetary sum merely because it may be capable of being valued at a point in time. Similar to the GORs at issue in this case, standard oil and gas GORs (including those granted under the 2015 CAPL Overriding Royalty Procedure) would also likely be characterized in substance as an interest in a continuing and inherent feature of the property, and therefore fall closer to the fee simple end of the 'interest in land spectrum', safe from a court's exercise of its 'vesting off' jurisdiction.

The second part of the framework considers whether the owner of the interest in land might have consented to the vesting off of the interest or subordination of the interest. This again, would be unusual in the typical grant of a GOR in the oil and gas context. That being said, this is an important consideration for drafters of customized royalty agreements to be aware of as subordination of the GOR interest to the interest of existing secured lenders is frequently a negotiated point on significant royalty transactions. Put differently, it is clear from this decision that the priority of interests is paramount and GOR holders should be sure to ensure such priority is reflected in the royalty agreement, and that there is no subordination to other interests, such as that of a secured lender.

While it seems likely that many standard oil and gas GORs would be protected from extinguishment under a vesting order on the basis of this framework, if it is still "ambiguous or inconclusive" at the end of the analysis, the court is then to consider the equities, including the prejudice to the royalty holder, whether the royalty holder could be adequately compensated for their interest, whether there is any evidence of value in the property itself, etc. in deciding whether to grant the vesting order extinguishing the third party interest.

While the Court of Appeal expressly sought to provide a framework for courts to approach the analysis as to whether or not a vesting order extinguishing a third party's interest is appropriate, it is not entirely clear, aside from consenting to one's interest being vested off, what specifically a court should consider in determining whether it is appropriate to vest off a third party's interest in land. The parameters of the inquiry remain somewhat vague, but given the potentially sweeping implications for holders of interests in land, it will be interesting to see if: (i) Third Eye takes steps to advance the Supreme Court of Canada leave to appeal application initiated after the first Ontario Court of Appeal decision, or (ii) 235 Co. pursues leave to appeal from this most recent judgment. While the practical outcome here may lessen the motivation to seek leave to appeal, the door may still be open for the Supreme Court of Canada to weigh in on the interest in land and vesting issues at play in the *Dianor* decisions.

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