Court File No. 10-8630-00CL

ONTARIO
SUPERIOR COURT OF JUSTICE
(COMMERCIAL LIST)

IN THE MATTER OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*, R.S.C., 1985 c. C-36, AS AMENDED

AND IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF NELSON FINANCIAL GROUP LTD.

Applicant

FACTUM AND BOOK OF AUTHORITIES OF DOUGLAS TURNER, Q.C., IN HIS CAPACITY AS THE REPRESENTATIVE COUNSEL FOR NOTEHOLDERS

(Motion returnable October 18, 2010)

October 4, 2010

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10 Harris, Jason and Hargovan, Anil, "The Intersection between Shareholders' and Creditors' Rights in Insolvency: an Australian Perspective" (2007) Ann. Rev. Insolv. Law 699

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1 *Securities Act*, R.S.O. 1990, c. S-5 at ss. 128(1) and 128(3), 4, 10, 13, 14 and 130.1

TAB 1

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PART I – NATURE OF THE MOTION

1. This motion asks this Honourable Court to determine the legal characterization of any claims that may have been filed by holders of preferred shares in the capital stock of the Applicant, Nelson Financial Group Ltd. The motion asks the Court to determine that any such claims as creditor constitute "equity claims" as such is defined in the *Companies' Creditors Arrangement Act* ("CCAA"), including, without limitation, for the purposes of s. 6(8) and s. 22.1 of the CCAA.

PART II – THE FACTS

2. The Applicant is incorporated under the *Business Corporations Act* of Ontario (the "OBCA") pursuant to Articles of Incorporation dated September 4, 1990 and Articles of Amendment dated April 5, 2007 and July 14, 2008.

Exhibits "H" and "I" to the Seventh Report of the Monitor dated September 13, 2010 (the "Seventh Report")

3. In accordance with its Articles as amended, the Applicant is authorized to issue two classes of common shares and two series of preferred shares. The president and sole director of the Applicant, Mr. Marc Boutet, is the owner of all of the issued and outstanding common shares.

4. By July 31, 2007, the Applicant had issued to investors 176,675 Series A preferred shares for an aggregate consideration of $4,416,925. During the subsequent fiscal year ended July 31, 2008, the Applicant issued a further 172,554 Series A preferred shares and 27,080 Series B preferred shares. These shares were issued for an aggregate consideration of $4,672,383 net of share issue costs.

Financial Statements of Nelson Financial Group Ltd. for fiscal year ended July 31, 2008 with comparable for year ended July 31, 2007, Exhibit "A" to the Affidavit of Marc Boutet sworn March 22, 2010

5. As of March 23, 2010, the Applicant had issued and outstanding Series A and Series B preferred shares with an aggregate stated capital of $14,647,914. The preferred shares are held by approximately 82 persons. As of the date of filing of these proceedings by the Applicant, there were some $53,632 of declared but unpaid dividends outstanding with respect to the preferred shares. The dividends on both the Series A and Series B preferred shares are cumulative.

Seventh Report at paragraph 19b

6. Investors subscribing for preferred shares of the Applicant entered into subscription agreements styled as term sheets, which were executed by both the investor and the Applicant.

Seventh Report at paragraphs 26, 27, 28, 29 and 30 and Exhibits "K", "L" and "M"

7. It appears that, in each case, share certificates for the preferred shares were issued to each investor and the Applicant maintained in its corporate records a share

register recording the name of each preferred shareholder and the number of shares held by such shareholder.

Seventh Report at paragraph 26

Supplemental to Seventh Report dated September 17, 2010 at paragraphs 7 and 8

Share Register produced by counsel to the Applicant

8. The Applicant did not provide financial statements to any of the holders of preferred shares prior to or subsequent to their investing in preferred shares of the Applicant. The Applicant was known by its sole director to have been insolvent since at least its financial year ended July 31, 2007.

Cross-examination of Marc Boutet held on August 17, 2010 at Questions 72, 73, 76, 77 through 79 and 134 through 137.

9. The Ontario Securities Commission has issued a Notice of Hearing and Statement of Allegations on May 12, 2010 alleging that the Applicant, its affiliate, Nelson Investment Group Ltd., and various officers and directors of those corporations committed breaches of the Ontario *Securities Act* in the course of selling preferred shares. The allegations include non-compliance with the prospectus requirements, the sale of shares in reliance upon exemptions that were not applicable, the sale of shares to persons who were not accredited investors and fraudulent and negligent misrepresentations made in the course of the sale of shares. Those allegations have not yet been determined and the hearing of the Commission has been scheduled for the last two weeks of February 2011.

Third Report of the Monitor dated June 11, 2010 at Exhibit "I"

10. It is contemplated that these factual circumstances might give rise to the holders of preferred shares asserting claims against the Applicant as creditors to recover monetary amounts on the following bases:

(a) Declared but unpaid dividends;

(b) Unperformed requests for redemptions;

(c) Compensatory damages for the loss resulting in the purchased preferred shares now being worthless and claimed to have been caused by the negligent or fraudulent misrepresentation of the Applicant or of persons for whom the Applicant is legally responsible; and

(d) Payment of the amounts due upon the rescission or annulment of the purchase or subscription for preferred shares.

Further, it appears that some preferred shares may have been issued to shareholders under a dividend reinvestment plan where the shareholder contends that its agreement with the Applicant was that the dividends were to be lent to the company as a shareholder loan and not to be reinvested in additional shares.

11. The Applicant and various creditors, including the holders of promissory notes represented by the Representative Counsel appointed pursuant to the order of this Honourable Court made on June 15, 2010, are seeking to formulate plans for the restructuring of the Applicant, including the terms for a plan of arrangement to compromise its debt obligations. Such efforts require clarity as to the characterization of claims that have been or could be asserted by any of the preferred shareholders.

PART III – THE ISSUES

12. The issue in this motion is whether or not, in a restructuring proceeding under the CCAA of the insolvent corporation, claims that may be advanced by preferred shareholders for damages, rescission or unpaid dividends can rank as unsecured creditor claims. It is argued that such claims are characterized as "equity claims" as defined in s. 2 for the purposes of, *inter alia*, ss. 6(8) and 21.1 of the CCAA, are to be placed in a separate class and are subordinated to the full recovery of all other creditors.

PART IV – THE LAW

(a) Background – Common Law Position

13. A contract to purchase shares in a corporation from Treasury is performed once the subscription price has been paid and the purchaser has been recorded on the register maintained by the Corporation as a shareholder. That is conclusively evidenced by either the entry on the share register or by the issuance and acceptance by the subscriber of a certificate for the purchased shares. Both of those steps appear to have been taken in respect of all of the persons designated as preferred shareholders on the records of the Applicant. Thereupon, the subscription agreement is fully executed.

14. Rescission of a contract is generally only available at common law when the contract has been fully executed if there is a showing by the innocent party seeking rescission that their entry into the contract was induced by a fraudulent misrepresentation. Such a fraudulent misrepresentation may consist of either a misstatement of fact known to be untrue or made with reckless disregard as to whether or not it was true. A fraudulent misrepresentation may also consist of the knowing and wilful omission to state a fact that would be known to be material to the innocent party entering into the contract.

15. Illegality connection with a contract may also give rise to remedies on the part of an innocent party to the contract. In the case of dealings in securities, the Ontario Securities Commission may apply to this Court seeking a declaration that a person or company has not complied with Ontario securities law. If this Court is satisfied on the material before it and grants the declaration, the Court may make any appropriate order against the person or company including an order rescinding any transaction entered into by the person or company relating to trading in securities, including the issuance of securities. The Court may also make an order directing the person or company to repay to a security holder any part of the

money paid for securities or to compensate or make restitution to any aggrieved person or to pay general or punitive damages to any person.

***Securities Act*, R.S.O. 1990, c. S-5 at ss. 128(1) and 128(3), 4, 10, 13 and 14**

16. The Securities *Act* also provides that where an offering memorandum contains a misrepresentation, a purchaser has a right of action for damages against the issuer and may also elect to exercise a right of rescission.

***Securities Act*, R.S.O. 1990, c. S-5 at s. 130.1**

(b) Claims of Shareholders upon Insolvency of Issuer at Common Law

17. In Canada and in England, it has been long established that claims and rights of shareholders will not be admitted as provable claims or will rank after creditors of an insolvent corporation in any liquidation, winding up or bankruptcy of the issuer corporation. This result applies in respect of any claim arising from or for the return of their equity investment. More recent cases have dealt with what might have been a more subtle issue as to whether the question or the result is or should be any different if the proceeding is concerned with an insolvent issuing corporation attempting to restructure under either a proposal or a plan of arrangement.

***Re Blue Range Resource Corp.*, (2000), 15 C.B.R. (4th) 169, 2000 ABQB 4 (Alta. Q.B.) at paras. 29 and 37 and cases cited therein.**

18. In *Re Blue Range Resource Corp.* Romaine, J. rejected a creditor claim made by a shareholder based upon fraudulent misrepresentations in publicly disclosed information on which the shareholder had relied in purchasing all of the shares of the insolvent corporation in a takeover transaction. She held that the claim was "in substance" a shareholder claim for a return of an equity investment and therefore ranked after the claims of unsecured creditors according to general principles of corporate law, insolvency law and equity. Her analysis addressed the

substance of the claim and found that the very core of the claim for damages was the holding of the shares of the insolvent corporation and as such the tort claim for misrepresentation derived from the shareholders status as a shareholder and not from a tort unrelated to that status. She held that the alleged loss "derives from and is inextricably intertwined with [the] shareholder interest in *Blue Range.* The nature of the claim is in substance a claim by a shareholder for a return of what it invested *qua* shareholder . . ."

***Re Blue Range Resource Corp.*, at para. 25**

19. When an issuing corporation becomes insolvent, there is an obvious desire of aggrieved shareholders to seek to elevate the possibilities of recovery upon their investment from equity to at least an unsecured creditor claim. The assertion of a claim for damages or for rescission and the recovery of the purchase price in the case of a treasury subscription produce an obvious benefit to the shareholder if such is allowed. As an American Court of Appeal recognized in 1896;

"*When a corporation becomes bankrupt, the temptation to lay aside the garb of a stockholder, on one pretence or another, and to assume the role of creditor is very strong and all attempts of that kind should be viewed with suspicion.*"

Newton National Bank v. Newbegin, (1896), 74 F. 135 at 142 (8th Cir.) cited in *Re Blue Range Resource Corp.* at para. 43.

20. This basic principle in liquidation cases came to be tested as restructuring cases had to deal with more sophisticated securities combining characteristics of equity with attributes analogous to debt. Preferred shares, particularly when either rights of redemption by the issuing corporation or retraction at the election of the holder were attached to them, raised characterization issues. These securities have attributes of equity and may have rights analogous to the rights of creditors. Retraction rights came before the Court of Appeal for Ontario in *Re Central Capital Corporation* in 1995 as a matter of first impression. The majority of the

Court held that the substance of the relationship between the holders and the corporation was that of shareholders and not creditors. Justice Laskin sets out an analysis of the characteristics of the shares in exploring the characterization question utilizing the principles established by the Supreme Court of Canada in *CDIC v. CCB*. He particularly noted that the share conditions were explicit that in liquidation, dissolution or winding up the preferred shareholders had priority over other classes of equity but would rank behind creditors. On that basis, Justice Laskin and Justice Weiler each concluded that the claims of the preferred shareholders were not claims that would be provable under the *Bankruptcy and Insolvency Act* and, consequently, were not claims that could be allowed as unsecured creditor claims in the CCAA proceeding

***Re Central Capital Corporation* (1996), 132 D.L.R. (4th) 223 (Ont. C.A.)**

***Canada Deposit Insurance Corp. v. Canadian Commercial Bank* (1992), 97 D.L.R. (4th) 385 (S.C.C.)**

21. The decision in *Re Central Capital Corporation* focused on the retraction rights held by the preferred shareholders and the argument of shareholders that, once those retraction rights were exercised, their relationship to the corporation changed such that they became creditors. It appears to have been common ground of all of the judges of the Court of Appeal that once the corporation became insolvent, the solvency requirements of the corporate statute prohibited it from paying the retraction price, purchasing or redeeming any of its shares. Justice Weiler emphasized that a necessary attribute of a provable claim is that it must be enforceable by legal process. The Court held that any claim for a dividend, repurchase or redemption amount could not be enforced by legal process once the corporation was insolvent.

22. The United States law, prior to statutory amendments in 1978, is instructive and persuasive authority in Canada. The decision of the Second Circuit Court of Appeal, *Re Stirling Homex Corp.* has been relied on by Canadian Courts. On the basis of an equitable analysis, the Second Circuit concluded that stockholders,

even those who have been allegedly defrauded, are subordinate to the general creditors when the corporation is insolvent. The Court pointed out that "*the real party against which [the stockholders] are seeking relief is the body of general creditors of their corporation. Whatever relief may be granted to them in this case will reduce the percentage which the general creditors will ultimately realize upon their claims.*" The Court held that it would not allow the claims of shareholders, even those based on alleged fraud in the course of the issuing of shares, to deplete further the already meagre pool of assets available to the general creditors. That result was subsequently codified in the United States bankruptcy statute in the 1978 amendments which were before Congress at the time of the decision.

***Re Stirling Homex Corp.*, (1978) 579 F. 2d 206 (2nd Cir. Ct. of App.)**

23. A similar circumstance came before Justice Romaine in Alberta in *Re Blue Range Resource Corp.* There a sole shareholder caused the issuing corporation to undertake a CCAA proceeding. In that proceeding, the shareholder claimed as a creditor for the damages that it had suffered because it had acquired the shares in a takeover transaction in reliance upon false public information filed by the corporation in breach of securities law. The claim was founded upon either negligent or fraudulent misrepresentation. Explicitly adopting the reasoning and conclusion of the United States Court in *Re Stirling Homex Corp.*, Justice Romaine held as follows:

> *Based on my characterization of the claim, the equitable principles and considerations set out in the American cases, the general expectations of creditors and shareholders with respect to priority and assumption of risk, and the basic equitable principle that claims of defrauded shareholders should rank after the claims of ordinary creditors in a situation where there are inadequate assets to satisfy all claims, I find that [the shareholder] must rank after the unsecured creditors of [the insolvent*

corporation] in respect of the alleged share exchange loss, the claim for transaction costs and the claim for cash share purchase damages.

***Re Blue Range Resource Corp.*, (2000), 15 C.B.R. (4th) 169, 2000 ABQB 4 (Ab. Q.B.) at paras. 43 through 57**

24. Justice Romaine set out policy reasons in support of her conclusion that claims made by shareholders to recover amounts that are directly connected to their status as shareholders should rank subordinate to the claims of unsecured creditors in a CCAA proceeding. Those policy reasons included the following:

(a) It is a fundamental corporate principle that claims of shareholders should rank below those of creditors in insolvency. Whatever the form in which the claim is advanced, it is in substance a claim by a shareholder for a return of what it paid for shares by way of damages;

(b) Creditors conduct business with corporations on the assumption that their claims will be given priority over shareholders in the event of an insolvency;

(c) In both Canada and the United Kingdom, once a company is insolvent, shareholders are not allowed to rescind their shares on the basis of misrepresentation and upon an insolvency, rights that a shareholder may have been entitled to prior thereto can be lost or limited on an equitable basis;

(d) Jurisprudence on the United States cases supports the priority of general creditors and the subordination of claims of shareholders even in cases where it is alleged that the shareholders were defrauded. This analysis is founded upon equitable principles, including the appreciation that the party against which the shareholders are effectively seeking relief is the body of general creditors whose recoveries will be reduced by any relief granted to the shareholders. This equitable analysis is persuasive to a Canadian Court; and

(e) To recognize and provide *pari passu* ranking to shareholder claims would result in many claims by aggrieved shareholders in insolvency situations. Such a result may greatly complicate the process of adjudicating claims under the CCAA and this is a factor to be considered by the Court although not itself determinative; ultimately, it is equitable to impose the risks of insolvency and illegality on the shareholders whose investment, by its very nature, was a risky one.

***Blue Range Resource Corp.*, at paras. 29, 33, 37, 42, 43, 44, 45 and 57**

25. The issue of shareholder claims and their rights as compared with unsecured creditor claims came up again came before the Alberta Court in a CCAA proceeding in 2001 in *National Bank of Canada v. Merit Energy Ltd.* Justice LoVecchio had to determine the rights of holders of flow-through shares of an insolvent oil and gas company. Due to its insolvency, the debtor company was in the process of selling off projects and had defaulted on its obligations to incur various Canadian exploration expenses and to disclaim the tax attributes of those expenses in favour of the holders of the flow-through shares. As part of the arrangements between the issuer and the shareholders, the debtor company had covenanted to indemnify the shareholders for any tax cost that they might incur by reason of such a default. Relying upon and approving the decision of Justice Romaine in *Blue Range*, Justice LoVecchio came to the conclusion that the indemnity provisions of the agreements between the shareholders and the debtor company were incidental to the rights of the claimants as shareholders and accordingly claims based on them were subordinated to unsecured creditor claims. The Court affirmed the approach used by Justice Romaine in *Blue Range Resource Corp.* It concluded that claims for rescission or for damages based on misrepresentation derive from the status of the claimants as shareholders of the debtor company. It held that the form of actions cannot overcome the substance of the claim which was that the shareholders were seeking to recoup, in substance, their investments in shares. The Court decided that such claims for the return of equity investment cannot rank with the debtor company's unsecured creditors. In dismissing an appeal from this decision, the Alberta Court of Appeal held that "*Characterization flows from the underlying right, not from the mechanism for its enforcement, nor from its non-performance.*"

***National Bank of Canada v. Merit Energy Ltd.* (2001) 28 C.B.R. (4th) 228, 2001 ABQB 583, (Alta.Q.B.) particularly at paras. 48 through 55. Affirmed (2002) A.J. No.6 (Alta. C. A.)**

26. In 2009, the characterization of rights under flow-through shares again came before the Alberta Court in *Re EarthFirst Canada Inc.* Justice Romaine considered contractual indemnity provisions which were substantially identical to those involved in *National Bank of Canada v. Merit Energy Ltd.* and came to the same conclusion. Justice Romaine also noted that the Court of Appeal for Alberta had upheld the decision of Justice LoVecchio and that decision determined the issue in the case before her. She went on to note that the then pending amendments to the CCAA incorporating the new statutory definition of "equity claims" and the required subordination of those claims in CCAA proceedings, although not yet in effect, would produce the same result.

***Re EarthFirst Canada Inc.* (2009), 56 C.B.R. (5th) 102, 2009 ABQB 316**

(c) The Amendments to the *Bankruptcy and Insolvency Act* and to the CCAA

27. Prior to the most recent round of amendments of both the *Bankruptcy and Insolvency Act* and the CCAA, there was no explicit statutory support for the result achieved in the cases discussed above. The first round of amendments enacted in 2005, but never proclaimed in force, partially addressed the issue. Commentators objected that these first amendments did not apply to all forms of equity interests and did not uniformly treat equity interests in BIA and CCAA reorganization cases or expressly provide for the subordination and non-voting status of equity interests. Bill C-62 introduced in 2007 further amended both the BIA and the CCAA by inserting the definitions of "equity claim" and "equity interest". This amendment also made the subordination explicit by adding s. 6(8) and amended s. 22.1 of the CCAA.

Steven G. Golick and Sellers, Edward A., **"Corporate Governance"** in **Canadian Bankruptcy & Insolvency Law,** Ben-Ishai, Stephanie and Duggan, Anthony (editors), Lexis Nexis, Toronto, 2007 at pp. 266-269

28. The statute now provides that an equity claim means a claim that is "in respect of an equity interest" and includes any claim for a dividend, a claim for a return of capital, a claim for a redemption obligation, claims for a monetary loss resulting

from the ownership, purchase or sale of an equity interest and claims for monetary loss resulting from the rescission or annulment of a purchase or sale of an equity interest. The definition also covers contribution or indemnity respecting any such claim. The statute further defines the term "equity interest" as meaning a share or any right or option to acquire a share in the company.

CCAA, s. 2(1)

29. These definitions are used in two sections of the CCAA. Section 6(8) now provides that no compromise or arrangement shall be sanctioned by the Court that provides for any payment on an equity claim unless it provides that all other claims are to be paid in full first. Secondly, in dealing with classes of creditors, s. 22.1 specifies that creditors having equity claims are to be in their own class and may not, as members of that class, vote at any meeting, unless the Court orders otherwise. The effect of these provisions is quite straightforward: all equity claims are subordinated to all other creditor claims for all purposes of a CCAA proceeding. The language of the statutory provisions is simple, unambiguous and provides a clear and specific test to deal with such claims.

CCAA, s. 6(8) and 22.1

30. From the analysis of the pre-amendment case law in Canada, it can be concluded that the amendments to the BIA and to the CCAA respecting "equity claims" principally codify the existing common law. With respect to matters such as the indemnity agreements relating to flow-through shares, the amendment confirms the analysis of *National Bank of Canada v. Merit Energy Ltd.* and of *Re EarthFirst Canada Inc.* It is significant that parliament has opted for a clear and simple test: any claim "in respect of a share of the debtor company" will be subordinated in its entirety.

31. Applying this codification to the circumstances of the Applicant leads to a clear conclusion. Any claims of preferred shareholders of the Applicant to recover for unpaid dividends, breaches of agreements to redeem their shares, damages for

negligent or fraudulent misrepresentation in connection with the sale of the shares or rescission of their purchases of shares and repayment of the purchase price will all constitute equity claims. All such claims are to be included in a separate class and are to be subordinate to the prior recovery in full of all other creditors' claims.

Gray, Andrew, "Equity Claims and the Reform of Insolvency Legislation", (June 2010), 22 Commercial Insolvency Reporter 48

32. It is evident from the publications of the Superintendent of Bankruptcy of Canada summarizing these legislative changes that the government interpreted the changes as providing a simple clear test. The summary of the effect of the introduction of the concept of "equity claim" into both the BIA and the CCAA is described in four straightforward sentences without qualification. There is no basis for the creating of equitable exceptions for hardship or for the weighing of responsibility among innocent parties.

Website of the Office of the Superintendent of Bankruptcy Canada, legislative changes, Treatment of Equity Claims

(d) Alternative Policy Considerations

33. It has been urged as a policy matter that the subordination of damage or rescission claims by shareholders should be ameliorated in circumstances where the shareholders have been victims of fraudulent issuances of their shares or breaches of the securities laws perpetrated by the issuing corporation or persons for whom it is responsible. It is said that the public interest in the effective and vigorous enforcement of securities law regulating the public markets is beneficial and will itself be benefited by additional remedies being provided to the purchasers of such securities when as is often the case the issuer becomes insolvent.

Sarra, Janis, "From Subordination to Parity: An International Comparison of Equity Securities Law Claims in Insolvency Proceedings", (2007), 16 Int. Insolv. Rev. 181

Harris, Jason and Hargovan, Anil, "The Intersection between Shareholders' and Creditors' Rights in Insolvency: an Australian Perspective" (2007) Ann. Rev. Insolv. Law 699

34. Nevertheless, the policy that Parliament has accepted applies a strict subordination of all claims that are substantively connected to equity shares. It appears that this is based upon the concept that the damage claims of purchasers of equity should not be born by the general body of creditors. Some commentators have noted that this might also have been motivated by a desire to make Canada a more attractive jurisdiction in which to conduct cross-border restructuring proceedings.

Harris, Jason et al, *op cit supra* at pp 731-2

35. Professor Janis Sarra is beyond any doubt the most respected academic in Canada in insolvency law. She offers the argument that equity investors "do not assume the risk of corporate fraud or violations of securities legislation, fair trade practices legislation or criminal codes." With the greatest of respect, this is not a universally true prospective. Equity investors do assume the risk of the personal characteristics of the management of the enterprise that they own, including intelligence, judgment and morality, of the persons whom they entrust with their investment. It is collectively the shareholders who have the authority and perhaps the responsibility to engage the managers and the power to replace them as needed. There is no basis upon which shareholders can be called upon to disgorge gains made by the enterprise when it successfully flouts the law of some jurisdiction or other or makes profits in excess of regulatory sanctions applied against it. As Justice Romaine remarked in *Blue Range Resources*, the shareholder assumes equity risks which a creditor does not. The choice of the quality of management is of the essence of the equity investment.

***Blue Range Resource Corp.*, at paras. 33 and 34**

36. It can equally be said that, of all of the stakeholders who might be called upon to share the burden of the losses of equity investors if their choice of management

proves to be defective, the general body of creditors does not immediately present itself as the most appropriate. When the legislature comes to address such a policy question, we might expect that it will be more concerned to impose personal liability upon the individuals who participated in or were complicit in any such breaches of securities law. The losses of shareholders should be imposed on the beneficiaries of the violations of securities law that particularly concern Professor Sarra. More typically, one might expect those to be parties such as incumbent management, the directors, controlling shareholders or the pre-existing shareholders.

37. Professor Sarra recommended in her 2007 paper that the BIA and the CCAA should be amended to permit the Court to allow an equity claim to rank as a creditor claim if the Court determines that such is "fair and equitable" or "fair and reasonable". What is clear is that Professor Sarra's thoughtful policy analysis and suggested alternative were offered and must have been known to the government before parliament chose to enact the amendments of Bill C-62. The government then waited some two years before proclaiming these amendments in force as of September 18, 2009. It may be reasonably assumed that parliament was aware of the policy alternatives between a simple and clear test (even though that may on occasion produce harsh results) and the delegation to judicial discretion as advocated by Professor Sarra. Parliamnet chose the simple unqualified language now in the amended statute. There is no easy answer to this policy debate beyond the clear understanding that any such proposed change to the law as presently enacted by parliament would require legislative initiative.

PART V – RELIEF REQUESTED

38. The Representative Counsel for the Noteholders of Nelson Financial Group Ltd. respectfully asks the Court to provide the following relief:

(a) An Order declaring that all claims and potential claims of holders of preferred shares of the Applicant made or asserted against the Applicant, Nelson Financial Group Ltd., including, without limitation, any claims for

unpaid dividends, redemption or retraction of such preferred shares, rescission of a purchase or subscription of such preferred shares or damages or other compensatory orders with respect to negligent or fraudulent misrepresentations made by or on behalf of the Applicant in connection with the sale or purchase of any such preferred shares shall for all purposes of these proceedings, including the claims procedure established under the Claims Procedure Order made by this Honourable Court on July 27, 2010, any plan of arrangement that may be filed by any person pursuant to the *Companies' Creditors Arrangement Act* and the conduct of any meeting and the taking of any vote with respect to any such plan of arrangement, be classified as "equity claims" within the meaning of the CCAA;

(b) An Order directing the Monitor acting under the Claims Procedure Order in assessing any claim that may have been or may hereafter be filed by any preferred shareholder of the Applicant that in any way relates to the preferred shares held by such claimant to designate such claim as an equity claim and not to allow such claim as an unsecured creditor claim;

(c) An Order directing that all equity claims shall form a separate class of claims and shall not be entitled to vote at any meeting of creditors called to consider any plan of arrangement that may be filed in this proceeding;

(d) An Order directing that any plan of arrangement to be proposed by any party in this proceeding must provide that all claims of unsecured creditors are to be paid in full before any equity claim is to be paid; and

(e) The full indemnity costs of the Representative Counsel to be paid by the Applicant forthwith.

All of which is respectfully submitted this 4th day of October, 2010.

Richard B. Jones
Special Counsel for Douglas Turner, Q.C.,
in his capacity as Court-appointed
Representative Counsel for the Noteholders
of Nelson Financial Group Ltd.

SCHEDULE "A"

List of Authorities

National Bank of Canada v. Merit Energy Ltd., (2001) ABQB 583

Re Central Capital Corporation (1996), 132 D.L.R. (4th) 223 (Ont. C.A.)

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Gray, Andrew, "Equity Claims and the Reform of Insolvency Legislation", (June 2010), 22 Commercial Insolvency Reporter 48

Website of the Office of the Superintendent of Bankruptcy Canada, legislative changes, Treatment of Equity Claims

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SCHEDULE "B"

List of Statutes

Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3, as amended

Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, as amended

Securities Act, R.S.O. 1990, c. S-5 at ss. 128(1) and 128(3), 4, 10, 13, 14 and 130.1

TAB 2

Court File No. 10-8630-00CL

ONTARIO
SUPERIOR COURT OF JUSTICE
(COMMERCIAL LIST)

IN THE MATTER OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*, R.S.C., 1985 c. C-36, AS AMENDED

AND IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF NELSON FINANCIAL GROUP LTD.

Applicant

BOOK OF AUTHORITIES OF DOUGLAS TURNER, Q.C., IN HIS CAPACITY AS THE REPRESENTATIVE COUNSEL FOR NOTEHOLDERS

(Motion returnable October 18, 2010)

TAB A

TAB 1

National Bank of Canada v. Merit Energy Ltd., 2001 ABQB 583

Date: 20010703
Action No. 0001-04994
Bankruptcy No. 073154

IN THE COURT OF QUEEN'S BENCH OF ALBERTA
JUDICIAL DISTRICT OF CALGARY

BETWEEN:

NATIONAL BANK OF CANADA, BANK ONE,
NA AND BANK ONE, CANADA

Plaintiffs

- and -

MERIT ENERGY LTD.

Defendant

- and -

IN THE MATTER OF THE BANKRUPTCY OF MERIT ENERGY LTD.

[Note: An Erratum has been filed on July 5, 2001; the correction has been made to the text and the Erratum is appended to this Judgment.]

[Note: An Erratum has been filed on July 9, 2001; the correction has been made to the text and the Erratum is appended to this Judgment.]

REASONS FOR JUDGMENT
of the
HONOURABLE MR. JUSTICE SAL J. LoVECCHIO

APPEARANCES:

Frank Dearlove and Chris Simard, Bennett Jones, LLP
for Arthur Andersen Inc.

William E. McNally, McNally and Cuming; David A. Klein, Klein Lyons
for Larry Delf, Representative Flow-Through Shareholder

Jim G. Shea, Shea Nerland Calnan
for the Flow-Through Shareholders who are not members of the Representative Class

Norman D. Anderson
agent for Magellan Aerospace Limited and Canada Dominion Resources Limited Partnership III

Matthew R. Lindsay and Phil J. Schreiber, Fraser Milner Casgrain
for the Underwriters except First Energy Capital Corporation

Tristram Mallet, Osler,Hoskin & Harcourt
for First Energy Capital Corporation

Douglas G. Stokes, Rooney Prentice
for certain Directors

D. Detomasi, Scott Hall
for Barry Stobo

Jeff Sharpe, Burnett Duckworth & Palmer
for Duncan Chisholm and Laurence Waller

Graham McLennan, McLennan Ross
for PriceWaterhouseCoopers LLP

Steven H. Leitl, Macleod Dixon
for National Bank of Canada, Bank One, NA and Bank One, Canada

INTRODUCTION

[1] On August 31, 2000, applications were brought by Dundee Securities Corporation, Peters & Co. Limited, Nesbitt Burns Inc., Newcrest Capital Inc., RBC Dominion Securities, Bunting Warburg Dillon Read Inc., First Energy Capital Corporation (being the underwriters in the flow-through common share offering of Merit Energy Ltd., described below), certain directors and officers of Merit Energy Ltd. and Larry Delf, a representative purchaser of flow-

through common shares in Merit, to determine whether these applicants were entitled to a priority in the nature of an equitable lien over the proceeds of the sale of Merit's assets.

[2] I dismissed the equitable lien applications. The Underwriters, except First Energy Capital Corporation, appealed that decision.

[3] Needless to say, the applicants wanted to be recognized as ordinary creditors of Merit in the event they did not have an equitable lien.

[4] Pending the hearing of the equitable lien appeal, the administration of the estate of Merit continued. As a result of my dismissal of the equitable lien claim, the Trustee anticipated that a fund of approximately $10 million would be available for distribution to unsecured creditors.

[5] Accordingly, the Trustee sought a determination as to the right of the Flow-Through Shareholders, the Underwriters and the Directors and Officers to be recognized as ordinary creditors of Merit and to be included in the distribution.

[6] I heard argument on that issue on April 30, 2001 but reserved my decision until the results of the appeal were known. On May 18, 2001, the appeal was heard and dismissed[1], so it is now appropriate to make the requested determination.

[7] The Trustee takes the position that the claims in issue are in substance claims by shareholders for the return of equity and, on the basis of the decision in ***Re: Blue Range Resource Corp.***[2], must rank behind the claims of Merit's unsecured creditors.

[8] Alternatively, the Trustee argues that their claims are too contingent to constitute provable claims under the ***Bankruptcy and Insolvency Act.*** [3]

[9] The Flow-Through Shareholders, the Underwriters and the Directors and Officers[4] submitted that their claims were in substance creditor claims and that they were not too contingent, thus qualifying them to rank as unsecured creditors in Merit's insolvency. If that position is sustained, the quantification of those claims will be a separate issue.

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[1] Reasons followed the dismissal from the bench 2001 ABCA 138.

[2] (2000), 15 C.B.R.(4th) 169 (Alta. Q.B.).

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

[4] PriceWaterhouseCoopers LLP, Merit's auditor at the material times, was not involved in previous applications but made similar submissions to the Underwriters, Directors and Officers. PriceWaterhouseCoopers' position will be addressed separately in these reasons.

BACKGROUND

[10] Merit was in the business of the exploration, development and production of natural gas and crude oil in Alberta and Saskatchewan.

[11] On July 15, 1999, the Underwriters entered into an underwriting agreement with Merit whereby they agreed to participate in a public offering of 2,222,222 Flow-Through Shares of Merit. Paragraph 16 of the Underwriting Agreement states in part:

> The Corporation shall indemnify and save each of the Indemnified Persons harmless against and from all liabilities, claims, demands, losses, (other than losses of profit in connection with the distribution of common shares), costs, damages and expenses to which any of the Indemnified Persons may be subject or which any of the Indemnified Persons may suffer or incur, whether under the provisions of any statute or otherwise, in any way caused by, or arising directly or indirectly from or in consequence of:
>
> (a) any information or statement contained in the Public Record (other than any information or statement relating solely to one or more of the Underwriters and furnished to the Corporation by the Underwriters for inclusion in the Public Record) which is or is alleged to be untrue or any omission or alleged omission to provide any information or state any fact the omission of which makes or is alleged to make any such information or statement untrue or misleading in light of all the circumstances in which it was made;
>
> (b) any misrepresentation or alleged misrepresentation (except a misrepresentation or alleged misrepresentation which is based upon information relating solely to one or more of the Underwriters and furnished to the Corporation by the Underwriters for inclusion in the Public Record) in the Public Record.

[12] The Underwriting Agreement provides in Paragraph 2 (entitled "Corporation's Covenants as to Qualification") that:

> [Merit] agrees:
>
> (a) prior to the filing of the Preliminary Prospectus and thereafter and prior to the filing of the Prospectus, to allow the Underwriters to participate fully in the preparation of the Preliminary Prospectus (excluding the documents incorporated therein by reference) and such other documents as may be required under the Applicable Securities Laws in the Filing Jurisdictions to qualify the distribution of the Common Shares in the Filing Jurisdictions and allow the Underwriters to conduct all due diligence which the Underwriters may reasonably require (including with respect to the documents incorporated therein by reference) in order to (i) confirm the Public Record is accurate and

current in all material respects; (ii) fulfill the Underwriters' obligations as agents and underwriters; and (iii) enable the Underwriters to responsibly execute the certificate in the Preliminary Prospectus or the Prospectus required to be executed by the Underwriters;

(b) the Corporation shall, not later than on July 19, 1999, have prepared and filed the Preliminary Prospectus...with the Securities Commissions...

(c) the Corporation shall prepare and file the Prospectus...as soon as possible and in any event not later than 4:30 p.m. (Calgary time) on August 3, 1999...

...

(e) that, during the period commencing with the date hereof and ending on the conclusion of the distribution of the Common Shares, the Preliminary Prospectus and the Prospectus will fully comply with the requirements of Applicable Securities Laws of the Filing Jurisdictions and, together with all information incorporated therein by reference, will provide full, true and plain disclosure of all material facts relating to the Corporation and the Common Shares and will not contain any misrepresentation; provided that the Corporation does not covenant with respect to information or statements contained in such documents relating solely to one or more of the Underwriters and furnished to the Corporation by one or more of the Underwriters for inclusion in such documents or omissions from such documents relating solely to one or more of the Underwriters and the foregoing covenant shall not be considered to be contravened as a consequence of any material change occurring after the date hereof or the occurrence of any event or state of facts after the date hereof if, in each such case, the Corporation complies with subparagraphs 3(a), (b), (c) and (d).

[13] In accordance with its covenant, Merit filed a Preliminary Prospectus and a Prospectus to qualify the shares for issue and ultimately the offering closed on August 17, 1999, at which time 2, 222, 222 Flow-Through Shares of Merit were issued.

[14] The Prospectus indicated that:

The gross proceeds of this Offering will be used to incur CEE in connection with the Corporation's ongoing oil and natural gas exploration activities. The Underwriters' fee and the expenses of this Offering will be paid from Merit's general funds...

The Flow-through Common Shares will be issued as 'Flow-through Shares' under the Act. The Corporation will incur on or before December 31, 2000, and renounce to each purchaser of Flow-through Common Shares, effective on or before December 31, 1999,

CEE in an amount equal to the aggregate purchase price equal to the aggregate purchase price paid by such purchaser.

Subscriptions for Flow-through Common Shares will be made pursuant to one or more subscription agreements ('Subscription Agreements') to made between the Corporation and one or more of the Underwriters or one or more sub-agents of the Underwriters , as agent for, on behalf of and in the name of the purchasers of Flow-through Common Shares...

[15] The Prospectus also indicated that:

... Pursuant to the Subscription Agreements, the Corporation will covenant and agree (i) to incur on or before December 31, 2000 and renounce to the purchaser, effective on or before December 31, 1999, CEE in an amount equal to the aggregate purchase price paid by such purchaser for the Flow-Through Common Shares and (ii) that if the Corporation does not renounce to such purchaser, effective on or before December 31, 1999, CEE equal to such amount, or if there is a reduction in such amount renounced pursuant to the provision of the Act and as the sole recourse of the purchaser for such failure or reduction, the Corporation shall indemnify the purchaser as to, and pay in settlement thereof to the purchaser, an amount equal to the amount of any tax payable or that may become payable under the Act...by the purchaser as a consequence of such failure or reduction...

In respect of CEE renounced effective on December 31, 1999, and not incurred prior to the end of the period commencing on the date that the Subscription Agreement is entered into and ending on February 29, 2000, the Corporation will be required to pay an amount equivalent to interest to the Government of Canada. Any amount of CEE renounced on December 31, 1999 and not incurred by December 31, 2000 will result in a reassessment of deductible CEE to subscribers. However, interest in respect of additional tax payable under the Act by a purchaser of Flow-Through Common Shares will generally not be levied in respect of such reassessment until after April 30, 2001.

[16] The Underwriters each entered into Subscription and Renunciation Agreements with Merit for the purchase of the Flow-Through Shares, containing the covenants described in paragraph 15 above.

[17] Merit did not incur CEE as anticipated and in fact only approximately $4 million (of the anticipated $15 million of CEE) was renounced to the Flow-Through Shareholders prior to Merit being placed in receivership, leaving an $11 million shortfall. As a result, those Flow-Through Shareholders, who anticipated tax deductions based on $15 million of CEE, were potentially faced with a tax problem.

[18] The Directors and Officers entered into indemnity agreements with Merit, which state in part that:

> To the full extent allowed by law, [Merit]...agrees to indemnify and save harmless the Indemnified Party, his heirs, successors and legal representatives from and against any and all damages, liabilities, costs, charges or expenses suffered or incurred by the Indemnified Party, his heirs, successors or legal representatives as a result of or by reason of the Indemnified Party being or having been a director and/or officer of [Merit] or by reason of any action taken by the Indemnified Party in his capacity as a director and/or officer of [Merit], including without limitation, any liability for unpaid employee wages, provided that such damages, liabilities, costs, charges or expenses were not suffered or incurred as a direct result of the Indemnified Party's own fraud, dishonesty or wilful default.

[19] Merit, the Underwriters and the Directors and Officers have been named as defendants in several actions commenced throughout Canada by or on behalf of the Flow-Through Shareholders. These actions allege that Merit, the Underwriters, the Directors and Officers and PriceWaterhouseCoopers are liable to the Plaintiffs because of misrepresentations made in the Prospectus. The Plaintiffs seek, *inter alia*, damages against all defendants, recission of their purchase of the Flow-Through Shares and damages for lost tax benefits associated with the Flow-Through Shares. The Underwriters have third-partied Merit and the Directors and Officers. As noted, the Underwriters and the Directors and Officers previously sought recognition as equitable lien holders (which was denied) and now they seek recognition as ordinary creditors.

[20] PriceWaterhouseCoopers was at all material times the auditor of Merit. As PriceWaterhouseCoopers had not yet filed a proof of claim at the time the Trustee filed its motion, the Trustee's materials did not address its claim as part of its application. However, the Trustee did not object to PriceWaterhouseCoopers participating in this application.

[21] PriceWaterhouseCoopers is in a similar position as the Underwriters and the Directors and Officers as it too has an indemnity from Merit and has also been sued by the Flow-Through Shareholders for misrepresentation. Its indemnity states that:

> Merit Energy Ltd. hereby indemnifies PriceWaterhouseCoopers LLP ("PriceWaterhouseCoopers")...and holds them harmless from all claims, liabilities, losses, and costs arising in circumstances where there has been a knowing misrepresentation by a member of Merit Energy Ltd.'s management, regardless of whether such a person was acting in Merit Energy Ltd.'s interest. This indemnification will survive termination of this engagement letter. This release and indemnification will not operate where PriceWaterhouseCoopers ought to have uncovered such knowing misrepresentation but failed to, due the gross negligence or willful misconduct of PriceWaterhouseCoopers, its partners and/or employees.

ISSUES

1. Are the claims of the Flow-Through Shareholders subordinate to the claims of Merit's unsecured creditors?

2. Are the claims of the Underwriters, the Directors and Officers and PriceWaterhouseCoopers subordinate to the claims of Merit's unsecured creditors?

DECISION - ISSUE 1

The claims of the Flow-Through Shareholders are subordinate to the claims of Merit's unsecured creditors as they are in substance shareholder claims for the return of an equity investment.

ANALYSIS

[22] Central to this application are the reasons of my sister Romaine J. in ***Re: Blue Range Resource Corp.***

[23] In that case, Big Bear Exploration Ltd. completed a hostile takeover for all of the shares of Blue Range Resource Corporation. After the takeover was completed, Big Bear alleged that the publicly disclosed information upon which it had relied in purchasing the Blue Range shares was misleading and that the shares were worthless. As sole shareholder, Big Bear authorized Blue Range to commence CCAA proceedings and then submitted a claim as an unsecured creditor in Blue Range's CCCA proceedings, based on the damages it alleged it had suffered as a result of Blue Range's misrepresentations.

[24] Romaine J. rejected Big Bear's attempt to prove as an unsecured creditor and held that Big Bear's claim was "in substance" a shareholder claim for a return of an equity investment and therefore ranked after the claims of unsecured creditors according to the general principles of corporate law, insolvency law and equity.

[25] Romaine J. stated at pp. 176-177:

> In this case, the true nature of Big Bear's claim is more difficult to characterize. There may well be scenarios where the fact that a party with a claim in tort or debt is a shareholder is coincidental or incidental, such as where a shareholder is also a regular trade creditor of a corporation, or slips and falls outside the corporate office and thus has a claim in negligence against the corporation. In the current situation, however, the very core of the claim is the acquisition of Blue Range shares by Big Bear and whether the consideration paid for such shares was based on misrepresentation. Big Bear had no cause of action until it acquired shares of Blue Range, which it did through share purchases for cash prior to becoming a majority shareholder, as it suffered no damage until it acquired such shares. This tort claim derives from Big Bear's status as shareholder, and not from a tort unrelated to that status. The claim for misrepresentation therefore is hybrid in nature and combines elements of both a claim

in tort and a claim as shareholder. It must be determined what character it has in substance.

It is true that Big Bear does not claim recission. Therefore, this is not a claim for return of capital in the direct sense. What is being claimed, however, is an award of damages measured as the difference between the "true" value of Blue Range shares and their "misrepresented" value - in other words, money back from what Big Bear "paid" by way of consideration...A tort award to Big Bear could only represent a return of what Big Bear invested in equity of Blue Range. It is that kind of return that is limited by the basic common law principle that shareholders rank after creditors in respect of any return on their equity investment. ...

I find that the alleged share exchange loss derives from and is inextricably intertwined with Big Bear's shareholder interest in Blue Range. The nature of the claim is in substance a claim by a shareholder for a return of what it invested qua shareholder, rather than an ordinary tort claim.

[26] Romaine J. went on at pp. 177-184 to describe five policy reasons which justified the conclusion that shareholders' claims such as Big Bear's should be ranked behind the claims of Blue Range's unsecured creditors. In summary, they are:

(i) the claims of shareholders rank behind the claims of creditors in insolvency;

(ii) creditors do business on the assumption that they will rank ahead of shareholders in the event of their debtor's insolvency;

(iii) shareholders are not entitled to rescind their shares on the basis of misrepresentation after the company has become insolvent;

(iv) United States jurisprudence supports the priority of creditors in "stockholder fraud" cases; and

(v) to allow the shareholders to rank *pari passu* with the unsecured creditors could open the floodgates to aggrieved shareholders launching misrepresentation actions.

[27] ***Re Canada Deposit Insurance* v. *Canadian Commercial Bank*** [5] is also central to this application. That case involved an issue of priorities with respect to the insolvency of the Canadian Commercial Bank. In an effort to preserve the bank, a participation agreement was entered into among the governments of Canada and Alberta, the Canada Deposit Insurance Corporation and six commercial banks. The sum of $255 million was advanced and it was to be repaid by CCB out of certain portfolio assets and pre-tax income. The agreement promised

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[5] (1992), 97 D.L.R. (4th) 358 (S.C.C)

an indemnity in the event of insolvency, and gave the participants a right to subscribe for shares in CCB at a named price.

[28] The Supreme Court of Canada held that although the participation agreement contained both debt and equity features, it was, in substance, a debt transaction. Iacobucci J. stated at p. 406:

> As I see it, the fact that the transaction contains both debt and equity features does not, in itself, pose an insurmountable obstacle to characterizing the advance of $255 million. Instead of trying to pigeon-hole the entire agreement between the Participants and C.C.B. in one of two categories, I see nothing wrong in recognizing the arrangement for what it is, namely, one of a hybrid nature, combining elements of both debt and equity but which, in substance, reflects a creditor-debtor relationship. Financial and capital markets have been most creative in the variety of investments and securities that have been fashioned to meet the needs and interests of those who participate in those markets. It is not because an agreement has certain equity features that a court must either ignore those features as if they did not exist or characterize the transaction on the whole as an investment. There is an alternative. It is permissible, and often required, or desirable, for debt and equity to coexist in the given financial transaction without altering the substance of the agreement. Furthermore, it does not follow that each and every aspect of such an agreement must be given the exact same weight when addressing a characterization issue. Again, it is not because there are equity features that it is necessarily an investment in capital. This is particularly true when, as here, the equity features are nothing more than supplementary to and not definitive of the essence of the transaction. When a court is searching for the substance of a particular transaction, it should not too easily be distracted by aspects which are, in reality, only incidental or secondary in nature to the main thrust of the agreement. [emphasis added]

[29] As noted, the Flow-Through Shareholders have commenced several actions. Against Merit, they seek recission or damages due to an alleged misrepresentation in the Prospectus (based on their statutory rights to these remedies as disclosed in the Prospectus). They also claim damages relating to lost tax benefits associated with the Flow-Through Shares. While this is a contractual remedy based on the Subscription and Renunciation Agreements, it also has elements of misrepresentation flowing from certain descriptive statements made in the Prospectus.

[30] The Flow-Through Shareholders submitted that they are entitled to be treated as creditors based on the actions they have commenced, but the Trustee objects to this treatment and has sought the direction of the Court in this regard.

i. The Trustee's Position

[31] The Trustee (through counsel) focussed on the allegations made in the statements of claim in its analysis. It suggested that the essential allegation of the Flow-Through Shareholders in their actions is misrepresentation and that as a result of such misrepresentation they have suffered damages. The Trustee then described the remedy sought as, in essence, a claim for a return of equity. The Trustee suggested that the claim for the anticipated tax benefits was no more than a claim for a benefit that was ancillary to their shareholding interest. The Trustee also described the Flow-Through Shareholders' application to prove as unsecured creditors as an attempt to take a "second kick at the can", following the failure of their equity investment.

[32] Using the reasoning of Romaine J. in ***Re: Blue Range Resource Corp***, the Trustee argued that the claim of the Flow-Through Shareholders must be subordinated to Merit's unsecured creditors. The Trustee submitted that all five policy reasons listed in that case (and described above) are present in this case, emphasizing that the dividend will be reduced 20 to 27% (from 15 to 11-12 cents) if the Flow-Through Shareholders' claims are included in the unsecured creditors' pool and that the facts in this case favour subordination even more than the facts in ***Re: Blue Range Resource Corp.***, as some of the Flow-Through Shareholders are seeking to rescind their purchase of the Flow-Through Shares in their actions.

ii. The Flow-Through Shareholders' Position

[33] Arguments were filed separately by Mr. McNally, as Counsel for Larry Delf (Mr. Delf being the designate of the Representative Flow-Through Shareholders group), and by Mr. Shea as Counsel for certain other Flow-Through Shareholders.

The Representative Flow-Through Shareholders Group's Position

[34] Mr. McNally did not take issue with the suggestion that as a general rule, shareholders rank after secured creditors. He also did not object to the reasoning of Romaine J. in ***Re: Blue Range Resource Corp.***, provided the case is limited to its context and not used to stand for the general proposition that in no circumstances may a shareholder ever have a claim provable in bankruptcy.

[35] Mr. McNally did object to the Trustee's characterization of the claim as a single claim for misrepresentation seeking damages equal to their purchase price for the shares. He suggested that the claims involved firstly, a right to damages or recission *qua* shareholder under securities legislation and secondly, a right to damages for breach of an indemnity provision *qua* debt holder. He also submitted that this latter claim may also be seen as having nothing to do with misrepresentation in the Prospectus or a return of capital, but arises independently as a result of Merit's failure to incur and then renounce CEE to the shareholders to enable them to obtain certain tax deductions.

[36] Mr. McNally suggested that this latter claim for tax losses was also a claim provable in bankruptcy. He referenced Laskin J.A.'s recognition in ***Re Central Capital Corporation*** [6] that shareholders may participate as creditors in the context of declared dividends because the liquidity provisions of corporate legislation would not have been triggered if the dividends had been declared prior to insolvency and would therefore be enforceable debts. Laskin J.A. stated at p.536:

> It seems to me that these appellants must either be shareholders or creditors. Except for declared dividends, they cannot be both... Moreover, as Justice Finlayson points out in his reasons, courts have always accepted the proposition that when a dividend is declared it is a debt on which each shareholder can sue the corporation.

[37] Mr. McNally also relied on ***Re G.M.D. Vending Co.*** [7] where the British Columbia Court of Appeal allowed declared but unpaid dividends to rank with other unsecured claims in a bankruptcy.

[38] He also emphasized that the CEE aspect of the relationship between the Flow-Through Shareholders, on the one hand, and Merit, the Underwriters and the Directors and Officers, on the other, possesses many of the indicia of debt mentioned by Weiler J.A. in ***Re Central Capital Corporation*** in that: (1) Merit is obliged to expend the funds raised by the Prospectus on CEE and the funds are advanced by Flow-Through Shareholders for this specific purpose alone, (2) there is an indemnity provision in the Prospectus itself to the Flow-Through Shareholders if this does not occur, evidencing an intention that the investors are to be fully repaid for the loss of the tax benefit,[8] and (3) interest becomes due for the amount of the failed tax write-off and is covered by the indemnity provision as tax payable.

[39] He suggested that the indemnity provisions in the Subscription and Renunciation Agreements are enforceable at law without consideration of corporate liquidity and are an acknowledgment of the unique commercial position of the Flow-Through Shareholders in the event that the CEE is not renounced. He concluded by submitting that the potential liquidity problem and contingent liability must constitute the rationale for the presence of the indemnity in the Subscription and Renunciation Agreements in the first place.

The Other Flow-Through Shareholders Group's Position

[40] Mr. Shea suggested that not only were the claims for tax losses relating to the CEE provable claims, the tort/statutory aspects of their claims were also provable claims, albeit they

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[6] (1996), 27 O.R. (3d) 494 (C.A.)

[7] (1994), 94 B.C.L.R. (2d) 130 (B.C.C.A.)

[8] See ***Ontario Securities Commission*** v. ***Consortium Construction Inc.*** (1993), 1 C.C.L.S. 117 at 138-139.

would be dealt with as "contingent" claims within the meaning of ss. 121 and 135 of the BIA[9]. He further submitted that the fact they are claims by shareholders is irrelevant.

[41] He relied on ***Gardner* v. *Newton*** [10] as authority for the proposition that a contingent claim is a claim that may or may not ripen into a debt depending on the occurrence of some future event. Mr. Shea also suggested that so long as the claim is not too remote or speculative, a claim, even though it has not yet been reduced to judgment, may still be a contingent claim. Mr. Shea pointed out that the Ontario Court of Appeal in ***Re Confederation Treasury Services Ltd.*** [11] departed from the earlier cases relied upon by the Trustee, including ***Claude Resources (Trustee of)* v. *Dutton*** [12]. The Court of Appeal stated they imposed too high

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[9] **121(1)** All debts and liabilities, present or future, to which the bankrupt is subject on the day on which the bankrupt becomes bankrupt or to which the bankrupt may become subject before the bankrupt's discharge ...shall be deemed to be claims provable in proceedings under this Act.**(2)** The determination whether a contingent or unliquidated claim is a provable claim and the valuation of such a claim shall be made in accordance with section 135.

135(1.1) The trustee shall determine whether any contingent or unliquidated claim is a provable claim, and, if a provable claim, the trustee shall value it, and the claim is thereafter, subject to this section, deemed a proved claim to the amount of its valuation.

[10] (1916), 29 D.L.R.276 (Man.K.B.)

[11] (1997), 43 C.B.R. (3d) 8.

[12] (1993), 22 C.B.R. (3d) 56 (Sask.Q.B.), referred to favourably by Farley J. in ***Canadian Triton International Ltd. (Re)*** (1997), 49 C.B.R. (3d) 192 (Ont. Gen. Div.) and followed in

of a threshold for the establishment of a contingent claim and held that it was not necessary to demonstrate probability of liability but merely to show they were not too remote or speculative.

[42] He asserted that the claims are not shareholder claims, but claims for statutory remedies and for breach of contract and must rank with Merit's other unsecured creditors for that reason. Mr. Shea also said the Court must look to the substance of the relationship between the claimant and the bankrupt and most importantly, the context in which the claim is made.

[43] Mr. Shea then argued that it would not be equitable to subordinate these claims while other claims based on tort, breach of contract or statutory remedy are allowed to rank as unsecured claims and concluded that the traditional principles for subordinating claims by shareholders do not apply to this case.

[44] He suggested that allowing claims for statutory remedies and/or breach of contract based on misrepresentation to rank as unsecured claims will not affect how creditors do business with companies. Further, he argued that allowing this result will not "open the floodgates" as the statutory remedies involved are narrow in scope and have strict and relatively short time frames.

iii. The Underwriters' Position

[45] Firstly, the Underwriters supported the Flow-Through Shareholders' submissions regarding the nature of their claims. They emphasized that ***Re: Blue Range Resource Corp*** should not stand for the proposition that shareholders must always be subordinated to unsecured creditors simply because they are shareholders. Rather, the nature and substance of their claims determines the treatment they receive in the estate.

[46] The Underwriters also suggested that ***Re: Blue Range Resource Corp*** turned on its unique facts of a purchaser of Blue Range shares having knowledge of misrepresentations yet exercising shareholder rights, such as authorizing the company to take CCAA proceedings and then making an unsecured claim in those proceedings for the loss associated with its share

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Re Wiebe (1995), 30 C.B.R. (3d) 109 (Ont. Gen. Div.)

purchase. The shareholder in that case did not claim recission and did not deny or attempt to avoid its shareholder status. Moreover, there was no contractual right to be treated by the company as anything but a shareholder.

[47] The Underwriters distinguished the claims of the Flow-Through Shareholders from those of Big Bear in ***Re: Blue Range Resource Corp*** as follows: (1) the Flow-Through Shareholders are not pursuing tort claims based on their status as shareholders, but rather are asserting a statutory right of recission, thereby refuting their status as shareholders, (2) the Flow-Through Shareholders also allege a direct contractual claim for indemnity against Merit pursuant to Subscription and Renunciation Agreements in which Merit agreed to incur qualifying expenditures (CEE), to renounce the resulting tax benefits to them and to indemnify them if it failed to incur the CEE, and (3) if their claims are ultimately successful, the Flow-Through Shareholders will be former shareholders and current creditors of Merit.

Resolution- ISSUE 1

[48] I agree with Romaine J. that the correct approach is to first examine the substance of the claim made against the insolvent. There are the two claims mentioned by counsel for the Flow-Through Shareholders. The first is an alternate remedy for damages or recission based on the alleged misrepresentations contained in the Prospectus. I was advised that some have advanced only one of these alternative claims. The second is cast as a claim in damages under the indemnity in the Subscription and Renunciation Agreements for the failure to renounce CEE.

[49] The Flow-Through Shareholders' claims for recission or damages based on misrepresentation derive from their status as Merit shareholders. Regardless of how they are framed[13], the form the actions take cannot overcome the substance of what is being claimed. It is plain from the Prospectus and the Subscription and Renunciation Agreements that the Flow-Through Shareholders invested in equity. It is equally plain from their actions that what they seek to recoup, in substance, is their investments. As in ***Re: Blue Range Resource Corp***, the "very core" of these claims arises from the circumstances surrounding the acquisition of Merit shares. The Flow-Through Shareholders had no cause of action until they acquired the Flow-Through Shares and their claims include a direct claim for return of capital in their request for recission and in the case of a damage claim, just as in ***Re: Blue Range Resource Corp***, the measure of damages enables them to recover the purchase price of the shares.

[50] It is true these shareholders are using statutory provisions to make their claims in damages or recission rather than the tort basis used in ***Re: Blue Range Resource Corp***, but in substance they remain shareholder claims for the return of an equity investment. The right to a return of this equity investment must be limited by the basic common law principle that shareholders rank after creditors in respect of any return of their equity investment.

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[13] Counsel described the claims variously as "statutory", "statutory/tort and "contractual"

[51] Now what about the second aspect of the claims?

[52] The second claim of the Flow-Through Shareholders has some of the features of a debt and the Subscription and Renunciation Agreements provide for a specific remedy in the event Merit fails to comply with its undertaking to make and renounce the CEE expenditures .

[53] While the discussion in ***Re Central Capital Corporation*** regarding the claim for declared dividends is appealing, it does not precisely apply in these circumstances. The tax advantages associated with flow-through shares is reflected in a premium paid for the purchase of the shares[14]. In essence, what happens in a flow- through share offering (as sanctioned by the ***Income Tax Act***[15]) is the shareholder buys deductions from the company. As the company has given up deductions, it wants to be paid for those deductions that it is renouncing. From the perspective of the purchaser of the shares, the premium for the shares would not have been paid without some assurance that the deductions will be available. I note the purchaser is also required to reduce their adjusted cost base of the shares (for tax purposes) by the amount of the deductions utilized by the purchaser.

[54] While the Flow-Through Shareholders paid a premium for the shares (albeit to get the deductions), in my view the debt features associated with the CEE indemnity from Merit do not "transform" that part of the relationship from a shareholder relationship into a debt relationship. That part of the relationship remains "incidental" to being a shareholder.

[55] In summary, the Flow-Through Shareholders' claims, regardless of the basis chosen to support them, are in substance claims for the return of their equity investment and accordingly cannot rank with Merit's unsecured creditors.

DECISION - ISSUE 2

> The claims of the Underwriters, the Directors and Officers and PriceWaterhouseCoopers are not subordinate to the claims of Merit's unsecured creditors as they are in substance creditors' claims that are not too contingent to constitute provable claims.

i. The Trustee's Position

[56] The Trustee argued that while on their face, the Underwriters' and the Directors and Officers' claims are not shareholder claims, "in substance", they are shareholders' claims and

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[14]V.M. Jog et al, "Flow Through Shares: Premium-Sharing and Trust-Effectiveness", (1996), 44 Can. Tax J. at p. 1017.

[15] R.S.C. 1985, (5th Supp.),c. 1.

are no more than an indirect passing-on to Merit of the Flow-Through Shareholders' claims. As a result, the Trustee submitted, equity dictates that since the Flow-Through Shareholders' claims must rank behind those of the unsecured creditors, the claims of the Underwriters and the Directors and Officers must fail as well. The Trustee suggested this subordination follows from the policy considerations set out by Romaine J. in ***Re: Blue Range Resource Corp***. Alternatively, the Trustee asserted that the claims of the Underwriters and the Directors and Officers are so contingent they must be valued at nil.

ii. The Underwriters' Position

[57] The Underwriters argued that regardless of how the Court characterized the Flow-Through Shareholders' claims, the Trustee cannot succeed against the Underwriters because: (1) the indemnity claims are based on contractual, legal and equitable duties owed to the Underwriters by Merit, to which the Flow-Through Shareholders are strangers and to which ***Re: Blue Range Resource Corp*** has no application; (2) equitable subordination has never been applied by Canadian courts and the Trustee cannot satisfy the test even if the court chooses to apply it, and (3) the Underwriters' claims are precisely the type of contingent claims contemplated by the BIA.

iii. The Directors' and Officers' Position

[58] The Directors and Officers conceded that, while some of the potential liability they face is as a result of the Flow-Through Shareholders' claims against them, or via indemnity claims brought by the Underwriters and Auditors against them, their claim is simply a claim in contract that is not an effort to obtain a return of equity. They argued that the enforceability of the indemnity is not contingent on the source of the potential liability.

[59] In any case, the Directors and Officers face claims other than from Merit's shareholders, which include: (1) a Saskatchewan action alleging the Directors and Officers assented to or acquiesed in Merit not paying its accounts and ought to be held liable for them, and (2) an Alberta action relating to ownership and lease payments on oilfield equipment. The Directors and Officers asserted that the existence of these claims demonstrate that they are not simply attempting to pass on shareholder claims, but rather they are making a contractual claim for all the potential liability they face, as the indemnity intends.

[60] The Directors and Officers also suggested that, as with the Underwriters, some of the contingency in their claim under the indemnity has been realized to the extent of legal fees incurred in defending the various actions. In any case, they agreed with the Flow-Through Shareholders and Underwriters that a contingent claim need not be "probable" in order to be "provable" but need only something more than to "remote and speculative in nature".

[61] Further, directors and officers require indemnities and commercial necessity dictates that these indemnities have real value.

Resolution - ISSUE 2

Nature of the Underwriters and the Directors' and Officers' claims against Merit

[62] The fundamental premise of the Trustee's argument is that the Underwriters' indemnity simply "flows through" or "passes on" the Flow-Through Shareholders' claim to Merit. This ignores the nature of the causes of action being advanced by the Underwriters and the existence of a contractual indemnity freely given by Merit for good and valuable consideration. The Trustee did not suggest that the indemnity was invalid or unenforceable, rather, it argued that this valid and enforceable right should be treated as a "shareholders' claim" and subordinated. With respect, I cannot agree with the Trustee's position.

[63] The Trustee's argument attempts to shift the Court's focus from the Underwriters' claim against Merit to the claim being asserted against the Underwriters, even though it is the former that the Trustee wants the Court to subordinate. The Flow-Through Shareholders' cause of action against the Underwriter's is predicated on the Underwriters' alleged failure to discharge a statutory duty and their liability is not contingent in any way on a successful claim by the Underwriters against Merit under the indemnity.

[64] The Underwriters' indemnity claims against Merit are not made as a shareholder or for any return of investment made by the Underwriters. Rather, they are based on contractual, legal and equitable duties owed directly by Merit to the Underwriters. Similarly, the other causes of action advanced by the Underwriters against Merit in the Third Party Notice do not arise from any equity position in the company, but are based on agency, fiduciary and contractual relationships between the Underwriters and Merit, to which the Flow-Through Shareholders are strangers and are unavailable for them to assert.

[65] For example, the Underwriters are entitled to an indemnity for defence costs even if the Flow-Through Shareholders' claims fail completely. The ultimate success or failure of the Flow-Through Shareholders' claims makes no difference to the existence and enforceability of this right against Merit.

[66] As the Underwriters' claims are not claims for a return of equity, ***Re: Blue Range Resource Corp*** does not apply. That decision only addressed equity claims of shareholders and I am not prepared to extend its application to the claims of the Underwriters in the application before me, simply because the claims triggering an indemnity by the Underwriters against Merit were shareholders' claims.

[67] As Firstenergy Capital Corp. emphasized, even if I were to apply the policy considerations for subordinating claims identified by Romaine J. in ***Re: Blue Range Resource Corp*** to the Underwriters' claims, these policy considerations support a conclusion that the Underwriters' claims are of the type I believe that Romaine J. would protect, not subordinate:

1. Shareholders rank behind creditors in insolvency - the issue here is whether the Underwriters are properly characterized as equity stakeholders or creditors. This is done by considering the substance of their claim. Regardless of how the Flow-Through Shareholders' claims are characterized, the substance of the Underwriters' claims against Merit are contractual. They arise out of a contract for indemnity between Merit and the Underwriters. This is clearly distinct from a claim for return of shareholders' equity. The Trustee asked the court to consider the fact of a possible future payment from the Underwriters to the Flow-Through Shareholders in characterizing the claim of the Underwriters against Merit. Given the nature of the obligations under an indemnity, this is inappropriate. Describing the Underwriters' claims as "no more than and indirect passing-on of the Flow-Through Shareholders' claims" is based on a flawed analysis of the obligations under an indemnity and ignores the statutory duty of the Underwriters to the Flow-Through Shareholders. There are two distinct obligations.

The first obligation relates to the Flow-Through Shareholders' claims against the Underwriters and any obligations that may be imposed on the Underwriters as a result. This obligation is completely unrelated to, and unaffected by the Underwriters' indemnity. The second obligation is between Merit, as indemnifier, and the Underwriters. This second obligation is the obligation that must be characterized in this application. The Flow-Through Shareholders are strangers to this claim.

2. Creditors do business with companies on the assumption they will rank ahead of shareholders on insolvency - the focus of this analysis is the degree of risk-taking respectively assumed by shareholders and creditors. Unlike shareholders who assume the risks of insolvency, the Underwriters bargained, as any other creditor, for their place at the creditor table in an insolvency. An indemnity is a well-known commercial concept business people routinely use to eliminate or reduce risk and should be recognized as a necessary and desirable obligation.

To subordinate the Underwriters' claim would amount to a reversal of the expectations of the parties to the indemnities. The evidence before me suggests that the Underwriters would not have participated in Merit's offering without the indemnity. I need not decide whether that is true.

Subordinating the Underwriters would fundamentally change the underlying business relationship between underwriters and issuers, and would be unexpected in the industry. Such a result might make it impossible for an underwriter to recover under an indemnity from a bankrupt issuer in respect of an equity offering.

3. Shareholders are not entitled to rescind shares after insolvency - this consideration has no bearing on the Underwriters as they are not shareholders seeking to rescind shares. Their claims against the bankrupt are for damages under a contract

for indemnity. Further, I was not asked to determine this particular question in this application.

4. The principles of equitable subordination - In ***Re Canada Deposit Insurance* v. *Canadian Commercial Bank***, the Supreme Court of Canada expressly left open the question of whether equitable subordination formed part of Canadian insolvency law, but expressed its opinion as to the applicable test as developed in the United States:

> ...(1) the claimant must have engaged in some type of inequitable conduct; (2) the misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and (3) equitable subordination of the claim must not be inconsistent with the provisions of the bankruptcy statute...(p. 420)

An application of these criteria would lead to the conclusion that equitable subordination would not apply in this case, even if it was part of Canadian law.

Although the Trustee suggested that the Underwriters may have "participated" in the misrepresentation, there is no evidence before me of inequitable conduct on their part. It is perhaps significant that the Flow-Through Shareholders have not alleged any such misconduct as against the Underwriters, but rather they have only advanced the statutory causes of action available to them under securities legislation.

As there is no evidence of inequitable conduct on the part of the Underwriters, there can be no corresponding injury to Merit's other creditors, or enhancement of the Underwriters' position.

Finally, the application of equitable subordination of the Underwriters' claims in this case would be inconsistent with the established priority scheme contained in the ***BIA***. The United States Supreme Court addressed this third requirement of consistency in ***United States* v. *Noland*** [16]:

> [t]his last requirement has been read as a 'reminder to the bankruptcy court that although it is a court of equity, it is not free to adjust the legally valid claim of an innocent party who asserts the claim in good faith merely because the court perceives the result as inequitable'

This statement encapsulates what the Trustee is asking to the Court to do: subordinate the claims of the Underwriters, who have asserted their claims under their indemnities as they are entitled to do, merely because the result may be perceived as inequitable. The words of the US Supreme Court are consistent with the view that equitable

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[16] (1996), 517 U.S. 535 at 539.

subordination is an extraordinary remedy that ought to be employed only where there is some misconduct on the part of the claimant. The statutory scheme of distribution in the ***BIA*** must be paramount, and if it is to be interfered with, it should only be in clear cases where demonstrable inequitable conduct is present.

5. Floodgates - Romaine J. considered that allowing Big Bear's claim for misrepresentation to rank with unsecured creditors would encourage aggrieved shareholders to claim misrepresentation or fraud. This consideration has no application to the Underwriters, who are not shareholders. Allowing the Underwriters' claims, which are based on a contractual right of indemnity, will not open the door to increased claims of misrepresentation or fraud by shareholders. The nature of the claims against the Underwriters and the Underwriters' claim against Merit are entirely different.

[68] In summary, the Underwriters' claims against Merit are creditors' claims which rank with Merit's other unsecured creditors.

[69] With this result I appreciate the potential for the Flow-Through Shareholders to be seen as obtaining some recovery from the estate before all the unsecured creditors are paid in full. It might even be suggested it may ultimately allow the Flow-Through Shareholders to achieve indirectly what they could not achieve directly, based on the substance of their claims. This may be the final economic result.

[70] However, success by the Flow-Through Shareholders against the Underwriters is not contingent upon success by the Underwriters against Merit nor does it automatically follow that success by the Flow-Through Shareholders against the Underwriters must inevitably lead to success by the Underwriters against Merit. A successful claim by the Underwriters against Merit will be determined on the basis of the provisions of the indemnity and the result of the claim against the Underwriters will be one of the factors in that analysis.

[71] As the possible economic result described in paragraph 69 does not flow from a continuous chain of interdependent events, the possibility that the Flow-Through Shareholders may indirectly recover some of their equity investment from others prior to Merit's unsecured creditors being paid in full would not be a sufficient reason to decide this application differently.

[72] As with the Underwriters, I find that the Directors and Officers have creditors' claims entitled to rank with Merit's other unsecured creditors.

Contingent claims

[73] While the Trustee's primary argument was the claims of the Underwriters and the Directors and Officers are merely indirect shareholder claims, alternatively, it argued that these claims are too contingent and cannot constitute a provable claim on that basis.[17]

[74] The Trustee relied on the case of ***Claude Resources (Trustee of)* v. *Dutton*** in support of its position. In that case, an indemnity agreement was executed between the bankrupt and its sole shareholder, officer and director and entitled the individual to be indemnified for any liabilities arising out of actions taken in his capacity as an officer and director of the bankrupt. This individual was sued in relation to a debenture offering and sought to prove using his indemnity. Noble J. described the claim as having a "double contingency", in that as a first step the action on the debenture offering must be successful, and if so, then the claim on the application of the indemnity agreement must also succeed. Noble J. held that more is needed beyond evidence that the creditor has been sued and that liability may flow; some element of probability is needed.

[75] The Trustee submitted that there is no evidence as to the potential success of the Flow-Through Shareholders' claims against the Underwriters and/or the Directors and Officers, nor was it possible prior to judgment in those actions, to determine whether any liability of the Underwriters and/or the Directors and Officers to the Flow-Through Shareholders would qualify for indemnification.

[76] The fact that a claim is contingent does not mean it is not "provable"[18]. Provable claims include contingent claims as long as they are not too speculative: ***Negus* v. *Oakley's General Contracting*** [19]. Section 121 defines provable claims to include "all debts and liabilities, present or future,...to which the bankrupt may become subject...".

[77] Section 121 does not specify the degree of certainty required to make a claim provable, other than to include as provable all debts or liabilities to which the bankrupt may become subject. As stated, the Ontario Court of Appeal addressed this in ***Re Confederation Treasury Services Ltd.*** and held that the test of probable liability set out in ***Claude Resources (Trustee of)* v. *Dutton*** and ***Re Wiebe*** (also relied on by the Trustee) imposed too high of a threshold to establish a valid contingent claim. Rather, the Ontario Court of Appeal expressed that contingent claims must simply be not too "remote or speculative in nature". I agree with the Ontario Court of Appeal's view of the test.

[78] On a plain reading of the Underwriting Agreement, the indemnity appears to be engaged by the Flow-Through Shareholders' actions. The actions are under case management

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[17] *Supra* footnote 9 for ***BIA*** definitions in ss. 121 and 135

[18] *ibid.*

[19] (1996), 40 C.B.R. (3d) 270 (N.S.S.C.)

and are proceeding through discoveries at this time. Further, there are several authorities that suggest an indemnity becomes enforceable as soon as a claim of the type indemnified is alleged.[20] Finally, at least one part of the Underwriters' claim is not contingent - they have incurred costs and disbursements in defence of the Flow-Through Shareholders' claims and according to the terms of the indemnity are currently entitled to reimbursement for those costs, regardless of the outcome of the litigation.

iv. PriceWaterhouseCoopers

[79] PriceWaterhouseCoopers made similar submissions to the Underwriters and the Directors and Officers and emphasized the strong policy reason behind supporting auditors' indemnities as unsecured and not subordinated claims. In addition, PriceWaterhouseCoopers has an independent claim for negligent misrepresentation against the Directors and Officers, arising out of the provision of information to PriceWaterhouseCoopers by Merit management which PriceWaterhouseCoopers alleges was known, or ought to have been known, to be incorrect. PriceWaterhouseCoopers suggested this further distinguishes PriceWaterhouseCoopers' situation from the situation before the Court in ***Re: Blue Range Resource Corp.***

[80] I find that PriceWaterhouseCoopers' indemnity claim is a creditor's claim entitled to rank with Merit's other unsecured creditors. My reasoning with respect to the Underwriters' claims, as based on their indemnities, applies equally to PriceWaterhouse Coopers' claim based on its indemnity.

[81] I am aware that the indemnities of the Flow-Through Shareholders are not being accorded creditor status, while those of the Underwriters, the Directors and Officers and PriceWaterhouseCoopers are. However, as noted, the indemnity feature of the Flow-Through Shareholders' claims is related to certain deductions and those deductions were part of the purchase price for the shares. This in my view is more analogous to ***Re Canada Deposit Insurance* v. *Canadian Commercial Bank*** than to ***Re Central Capital Corporation*** and that to me is sufficient to justify the distinction.

CONCLUSION

[82] The claims of the Flow-Through Shareholders are in substance claims for the return of equity investment and rank behind the claims of Merit's unsecured creditors, which shall include the claims of the Underwriters, the Directors and Officers and PriceWaterhouse Coopers.

[83] If the parties cannot agree on costs, they may see me within 30 days.

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[20] See for example, ***Re Froment; Alta. Lumber Co.* v. *Department of Agriculture*** ,[1925] 2 W.W.R. 415 (Alta. S.C.)

HEARD on the 30th day of April 2001.
DATED at Calgary, Alberta this 3rd day of July 2001.

J.C.Q.B.A.

An errata has been issued for the above Judgement as follows:

ERRATA OF THE REASONS FOR JUDGEMENT
OF THE HONOURABLE MR. JUSTICE SAL J. LoVECCHIO

The Appearances have been revised to include Mr. David A. Klein. Mr. Klein of Klein Lyons attended with Mr. William E. McNally of McNally and Cuming, for Larry Delf, Representative Flow-Through Shareholder.

An errata has been issued for the above Judgement as follows:

ERRATA OF THE REASONS FOR JUDGEMENT
OF THE HONOURABLE MR. JUSTICE SAL J. LoVECCHIO

Please replace page 2 of your copy of the Judgement.

The initials Q.C. should not follow the name of Douglas G. Stokes, of Rooney Prentice.

TAB 2

C21479 C21477

COURT OF APPEAL FOR ONTARIO

FINLAYSON, WEILER and LASKIN JJ.A.

IN THE MATTER OF Central Capital Corporation;
AND IN THE MATTER OF THE Companies' Creditors Arrangement Act,
R.S.C. 1985, c. 36, as amended

AND IN THE MATTER OF AN APPEAL FROM THE DISALLOWANCE OF THE CLAIMS OF JAMES W. McCUTCHEON, CENTRAL GUARANTEE TRUST COMPANY, AS TRUSTEE FOR THE REGISTERED RETIREMENT SAVINGS PLAN OF JAMES W. McCUTCHEON AND CONSOLIDATED S.Y.H. CORPORATION BY PEAT MARWICK THORNE INC. ADMINISTRATOR OF CERTAIN ASSETS OF CENTRAL CAPITAL CORPORATION

B E T W E E N :	)	
	)	
ROYAL BANK OF CANADA, BANCA COMMERCIALE ITALIANA OF CANADA, CREDIT LYONNAIS CANADA, DAI-ICHI KANGYO BANK (CANADA), PRUDENTIAL ASSURANCE COMPANY LIMITED, PRUDENTIAL GLOBAL FUNDING, INC., SANWA BANK CANADA, THE BANK OF TOKYO CANADA, THE TORONTO-DOMINION BANK, WESTDEUTSCHE LANDESBANK GIROZENTRALE, BACOB SAVINGS BANK s.c., BANCA NAZIONALE DEL LAVORO OF CANADA, BANCO DI ROMA (LONDON), COMMERZBANK INTERNATIONAL S.A., CREDIT COMMERCIAL DE FRANCE, CREDIT COMMUNAL DE BELGIQUE S.A., CREDIT SUISSE (LUXEMBOURG) S.A., DG BANK LUXEMBOURG S.A.) KREDIETBANK NV (BELGIUM), NIPPON TRUST BANK LIMITED, OLFRN INVESTMENT (PANAMA) INC., PAUL REVERE LIFE INSURANCE, RBC FINANCE B.V., SCOR REINSURANCE COMPANY OF CANADA, SOCIETE GENERALE, THE BANK OF TOKYO, LTD., THE CHIBA BANK LTD., THE	)	**Bryan Finlay, Q.C. and John M. Buhlman for James W. McCutcheon and Central Guaranty Trust** **James H. Grout and Anne Sonnen for Consolidated S.Y.H. Corporation** **Terence J. O'Sullivan and Paul G. Macdonald for the Unsecured Creditors of Central Capital Corporation**

DAI-ICHI KANGYO BANK, LTD. (ATLANTA), THE HOKURIKU BANK LTD., THE JOROKU BANK LTD., THE KYOWA SAITAMA BANK (CHICAGO), LAURENTIAN BANK OF CANADA, LAURENTIAN GROUP CORPORATION AND IMPERIAL LIFE ASSURANCE COMPANY OF CANADA, THE LONG-TERM CREDIT BANK OF JAPAN, LTD., THE MARITIME LIFE ASSURANCE COMPANY, THE MITSUBISHI TRUST AND BANKING CORPORATION, THE SANWA BANK, LIMITED (LONDON), THE SHOKO CHUKIN BANK (NEW YORK) and THE TOHO BANK, LTD.	)	**Neil C. Saxe for Peat Marwick Thorne Inc.**
Applicants	)	**Heard: August 17, 1995**
- and -	)	
CENTRAL CAPITAL CORPORATION	)	
Respondent	)	

FINLAYSON J.A. (dissenting):

The appellant James W. McCutcheon and Central Guarantee Trust Company as Trustee for the Registered Retirement Savings Plan of James W. McCutcheon (hereinafter sometimes referred to collectively as "McCutcheon") and the appellant Consolidated S.Y.H. Corporation ("SYH") appeal from the order of The Honourable Madam Justice Feldman of the Ontario Court (General Division) dated January 9, 1995 [reported as *Central Capital*

Corp. (1995), 29 C.B.R. (3d) 33]. Feldman J. dismissed appeals from decisions dated January 20, 1993 and February 16, 1993 of the respondent Peat Marwick Thorne Inc., in its capacity as Interim Receiver, Manager and Administrator ("Administrator") of certain assets of Central Capital Corporation ("Central Capital"). The Administrator disallowed Proofs of Claim submitted by the appellants with respect to a Plan of Arrangement under the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36 ("*CCAA*"). Leave to appeal the order of Feldman J. was granted on March 17, 1995 by The Honourable Mr. Justice Houlden.

Overview of the proceedings

These appeals arise out of the insolvency of Central Capital which in and prior to December 1991 defaulted under its obligations to various unsecured lenders, note holders and subordinated debt holders. In early December of 1991, Central Capital advised its creditors that, pending implementation of new financial arrangements, it had decided to discontinue payment of all interest and principal due under outstanding loans, with the exception of indebtedness due under secured notes issued to The Royal Trust Company. In an Agreed Statement of Facts, which was prepared by the parties for the purposes of appeals from the disallowances of the Administrator, it was agreed that at all material times since in or prior to December 1991, Central Capital was insolvent. It had a total unsecured debt of $1,577,359,000 and, among other things:

(a) it was unable to pay its liabilities as they became due; and

(b) the realizable value of its assets was less than the aggregate of its liabilities.

By Notice of Application issued June 12, 1992, thirty-nine of the creditors commenced an application pursuant to the *CCAA* for an order declaring the following: that Central Capital was a debtor company to which the *CCAA* applied; that Peat Marwick Thorne Inc. be appointed Administrator of the property, assets and undertaking of Central Capital; that a stay of proceedings against Central Capital, except with leave of the court, be granted and; that the applicants be authorized and permitted to file a plan of compromise or arrangement under the *CCAA*.

By order of Houlden J. made June 15, 1992, Central Capital was declared to be a company to which the *CCAA* applied and all proceedings against Central Capital were stayed. By further order of Houlden J. made July 9, 1992, it was provided, among other things, that:

(a) Peat Marwick Thorne Inc. was appointed Administrator, Interim Receiver and Manager of such of the undertaking, property and assets of Central Capital as necessary for the purpose of effecting the transaction described in the order pursuant to which specified significant assets of Central Capital would be transferred to a newly incorporated company called Canadian Insurance Group

Limited ("CIGL");

(b) the Administrator was authorized to enter into and carry out a Subscription and Escrow Agreement with creditors of Central Capital pursuant to which creditors of Central Capital would be entitled to elect to exchange a portion of the indebtedness owing to them by Central Capital for shares and debentures to be issued by CIGL;

(c) the Administrator was authorized and directed to supervise the calling for claims of creditors of Central Capital who elected to exchange a portion of the indebtedness from Central Capital for shares and debentures to be issued by CIGL as aforesaid; and

(d) Central Capital was authorized and permitted to file with the court a formal plan of compromise or arrangement with Central Capital's secured and unsecured creditors and shareholders in accordance with the *CCAA* and the *Canada Business Corporations Act*, R.S.C. 1985, c. C-44 (the "*CBCA*") which would provide for the restructuring and reorganization of the debt and equity of Central Capital in the manner set out in the said order.

According to the Agreed Statement of Facts, the order of Houlden J. was made without prejudice to the rights of the appellants to assert claims as creditors in the CIGL transaction. Pursuant to the terms of the July 9, 1992 order, all claims of creditors of Central

Capital who wished to participate in CIGL were required to be submitted to the Administrator by September 8, 1992, or such other date fixed by the court. The Administrator received claims from various persons who wished to participate, including the claims submitted by the appellants herein.

The Administrator disallowed the claims of McCutcheon and SYH by Notices of Disallowance dated January 20, 1993 and February 16, 1993 in which various reasons were cited as to why the appellants did not qualify as creditors. The effect of this disallowance was that McCutcheon and SYH could participate only as shareholders in the plan of compromise and arrangement under the *CCAA* to be put forward by Central Capital. In dismissing the appeals from this disallowance, Feldman J. found that the appellants were not creditors because they did not have a claim provable under the *Bankruptcy Act (Canada)*, R.S.C. 1985, c. B-3 ("*Bankruptcy Act*").

Issue

The Agreed Statements of Facts sets out the issue in the appeal in the following language:

> Do the appellants, or any of them, have claims provable against CCC [Central Capital] within the meaning of the *Bankruptcy Act (Canada)*, as amended as of the date of the Restated Subscription and Escrow Agreement? If the appellants, or any

> of them, have provable claims, then the proof of claim of any appellant that has a claim provable is to be allowed as filed and the appeal from the disallowance allowed, and the appellants, or any of them, whose claim is allowed, are to participate in the Plan of Arrangement of Central Capital as a senior creditor.

The determination of this issue was deferred by Houlden J.'s order of October 27th, 1992. He ordered therein that preferred shareholders who had filed claims against Central Capital as creditors were not permitted to vote at the meeting of creditors called to consider the Plan of Arrangement "...but such is without prejudice to the rights of those claimants to prosecute their claims as filed". The last paragraph in the order ended:

> For greater certainty, the validity of any claim filed by a preferred shareholder shall not be affected by the terms of this paragraph.

Overview of the restructuring of Central Capital

The order of Houlden J. of July 9, 1992 directed the restructuring of Central Capital under the *aegis* of the court. The order, and others that would follow, contemplated that the restructuring would take place in two stages. The first stage involved the transfer to the Administrator of certain major assets of Central Capital to a company to be incorporated called Central Insurance Group Limited (CIGL). This company is frequently referred to in the documentation and the reasons of Feldman J. as "Newco". CIGL was then to be owned by those Central Capital creditors who chose to participate in the reorganization by accepting a reduction in their debts due from Central Capital and exchanging this reduced indebtedness

for debentures in CIGL. Subscription for debentures by this means additionally entitled the creditors to subscribe for shares in CIGL. Our understanding from counsel is that the assets transferred to CIGL included the assets acquired by Central Capital from the appellants in purchase agreements described later in these reasons.

The court approved a Subscription and Escrow Agreement setting out this arrangement. In order to participate, the creditors were required to file with the Administrator a Proof of Claim in the prescribed form along with other documents confirming the creditor's intention to reduce its claim against Central Capital and to subscribe for debentures and shares of CIGL. Claims were to be based on Central Capital's indebtedness to creditors as of June 15, 1992, the date of the court-ordered stay of proceedings. This transaction was completed on October 1, 1992 and resulted in CIGL being owned by the creditors of Central Capital in exchange for a reduction in Central Capital's unsecured debt in the amount of $603,000,000.

The second stage of the restructuring involved a Plan of Arrangement under the *CCAA*. That plan as put forward by Central Capital recognized four classes of creditors, only one of which, namely that of "Senior Creditors", could apply to the appellants. The Plan of Arrangement, as amended, provided that Central Capital would issue to Senior Creditors *pro rata* on the basis of their senior claims a class of secured promissory notes in

the aggregate principal amount of $20,000,000 of secured debt, which were to be known as first secured notes. A similar arrangement was made for the issuance of $1,000,000 of second secured promissory notes to subordinated creditors. Senior and subordinated creditors included any creditor whose claim had been allowed under the CIGL claims procedure in the first stage, to the extent of that creditor's reduced claim.

The Plan of Arrangement also called for the creation of a new class of shares in Central Capital to be called the Central New Common Shares. Central Capital would issue to the above Senior and Subordinated Creditors ninety percent of the new share capital of Central Capital in extinguishment of the balance of their debt. The Central Capital shareholders of all classes would have their existing shares converted into the remaining ten percent of the Central New Common Shares. All of the existing preferred and common shares would be cancelled upon implementation of the plan.

The amended Plan of Arrangement was ultimately voted on and approved by all four classes of creditors of Central Capital. On December 18, 1992, Houlden J. sanctioned this plan of arrangement under the *CCAA*. He authorized and directed Central Capital to apply for Articles of Reorganization pursuant to s.191 of the *CBCA*, so as to authorize the creation of the Central New Common Shares for implementation of the amended Plan of Arrangement. He also lifted the stays of proceedings affecting Central

Capital and its ability to carry on business as of January 1, 1993.

The effect of the amended Plan of Arrangement after approval was that all remaining debts and obligations owed by Central Capital to its creditors on or before June 15, 1992 were extinguished and all outstanding and unissued shares of any kind in Central Capital were cancelled and replaced by Central New Common Shares. Central Capital was then free to carry on business. It was no longer insolvent.

Facts as they relate to the claim of McCutcheon

By a Share Purchase Agreement dated June 15, 1987 between Central Capital and Gormley Investments Limited ("Gormley") and Heathley Investments Limited ("Heathley"), Central Capital agreed to purchase all Class "B" Voting Shares of Canadian General Securities Limited ("CGS") that were owned by Gormley and Heathley. James W. McCutcheon and his brother, who were the sole shareholders of Gormley, represented to Central Capital that CGS owned substantially all of the shares of Canadian Insurance Sales Limited, which in turn owned substantially all of the shares in a number of operating insurance, credit and trust companies. The consideration for the purchase of the CGS shares was $575 per share. The vendors were to be paid $400 per share in cash on closing and were to receive seven Series B Senior Preferred Shares of Central Capital. These shares contained a retraction clause entitling the holder to retract each preferred share on July 1, 1992 for $25.

Failing issuance of the shares by Central Capital, the vendors were to receive an additional $175 for each CGS share. The Share Purchase Agreement and later the Articles of Central Capital further provided that the holders of Series B Senior Preferred Shares were entitled to receive dividends as and when declared by the directors of Central Capital out of monies of the corporation properly applicable to the payment of dividends and in the amount of $1.90625 per share per annum (being 7 5/8% per annum on the stated capital of $25 per share) payable in equal quarterly payments. No dividends were in fact declared.

The Certificate of Amendment for Central Capital dated July 30, 1987, and the Articles of Amendment setting out the provisions attaching to the Series B Senior Preferred Shares contain all the terms and conditions governing the said shares. I am setting out below a description of those that are relevant to this appeal.

Pursuant to Article 4.1 of the Senior Series B Provisions, each holder of Series B Senior Preferred Shares was entitled, subject to and upon compliance with the provisions of Article 4, to require Central Capital to redeem all or any part of the Series B Senior Preferred Shares registered in the name of that holder on July 1, 1992 at a price equal to $25 per share, plus all accrued and unpaid dividends thereon, calculated to but excluding the Retraction Date.

Article 4.2 of the Senior Series B Provisions sets out the procedure for retraction of the shares. Article 4.3 of the Senior Series B Provisions provides that if the redemption by Central Capital of all of the Series B Senior Preferred Shares required to be redeemed on the Retraction Date would be contrary to applicable law or the rights, privileges, restrictions and conditions attaching to any shares of Central Capital ranking prior to Series B Senior Preferred Shares, then Central Capital shall redeem only the maximum number of Series B Senior Preferred Shares which it determined was permissible to redeem at that time. Article 4.3 provides the mechanism for a *pro rata* redemption from each holder of the tendered Series B Senior Preferred Shares and redemption of the tendered Series B Senior Preferred Shares by Central Capital at further dates.

Article 4.4(a) provides that subject to Section 4.4(b), the election of any holder to require Central Capital to redeem any Series B Senior Preferred Shares shall be irrevocable upon receipt by the transfer agent of the Certificates for the shares to be redeemed and the signification of election of the holder of the Series B Senior Preferred Shares.

Article 4.4(b) of the Senior Series B Provisions provides that if the retraction price is not paid by Central Capital, Central Capital shall forthwith notify each holder of the Series B Senior Preferred Shares who has not received payment for his deposited shares of

the holder's right to require Central Capital to return all (but not less than all) of the holder's deposited Share Certificates and the holder's rights under Article 4.3 outlined above.

Article 4.5 of the Senior Series B Provisions provides that the inability of Central Capital to effect a redemption shall not affect or limit the obligation of Central Capital to pay any dividends accrued or accruing on the Series B Senior Preferred Shares from time to time not redeemed and remaining outstanding.

Article 7 of the Series Senior B Provisions provides that in the event of the liquidation, dissolution or winding-up of Central Capital, whether voluntary or involuntary, or any other distribution of assets of Central Capital among its shareholders for the purposes of winding up its affairs, the holders of the Series B Senior Preferred Shares shall be entitled to receive, from the assets of Cental Capital, $25 per Series B Senior Preferred Shares, plus all accrued and unpaid dividends thereon, to be paid prior to payment to junior ranking shareholders. Upon payment of such amounts, the holders of the Series B Senior Preferred Shares shall not be entitled to share in any further distribution of assets of Central Capital.

A Notice of Retraction Privilege was sent by Central Capital to the holders of Series B Senior Preferred Shares with a cover letter dated April 23, 1992. The letter stated, among other things, that Central Capital would not redeem any shares because the

redemption of such shares would be contrary to applicable law in the context of Central Capital's then current financial situation. McCutcheon and Central Guaranty Trust deposited for redemption 406,800 and 26,000 Series B Senior Preferred Shares, respectively, in accordance with the Senior Series B Provisions and the Notice of Retraction Privilege. The shares were deposited on May 28, 1992, with Montreal Trust Company of Canada, pursuant to the Notice of Retraction Privilege. The shares were properly tendered for redemption in the manner and within the time required by Central Capital's Articles of Amendment.

Central Capital did not pay the redemption price on July 1, 1992 and on July 20, 1992 it notified each holder of Series B Senior Preferred Shares of its right to require Central Capital to return all of the holder's deposited Share Certificates as required by Article 4.4(b) of the Senior Series B Provisions. McCutcheon and Central Guaranty Trust did not exercise that right.

Pursuant to the terms of Houlden J.'s order of July 9, 1992 directing the restructuring of Central Capital, McCutcheon submitted to the Administrator, as a creditor of Central Capital, Proofs of Claim dated September 3, 1992 and September 4, 1992, respectively. McCutcheon claimed the amount of $10,913,593.69 in respect of his Series B Senior Preferred Shares tendered for redemption. Central Guaranty Trust claimed the amount of $697,526.68 in respect of its tendered 26,000 Series B Senior Preferred Shares.

McCutcheon also executed and submitted the Restated Subscription and Escrow Agreement and other documents electing to participate in CIGL. These claims were completed and submitted in the prescribed form and within the time required by Houlden J.'s order.

As was previously noted, these claims were disallowed by the Administrator. The substance of the Administrator's reasons for disallowance was that the ability of Central Capital to redeem these preference shares is restricted by the provisions of the *CBCA* and it would be contrary to applicable law to redeem the shares in the context of Central Capital's financial position. The relevant provision of the *CBCA* provides:

> 36.(1) **Redemption of shares.** Notwithstanding subsection 34(2) or 35(3), but subject to (2) and to its articles, a corporation may purchase or redeem any redeemable shares issued by it at prices not exceeding the redemption price thereof stated in the articles or calculated according to a formula stated in the articles.
>
> (2) **Limitation.** A corporation shall not make any payment to purchase or redeem any redeemable shares issued by it if there are reasonable grounds for believing that
>
> (a) the corporation is, or would after the payment be, unable to pay its liabilities as they become due; or
>
> (b) the realizable value of the corporation's assets would after the payment be less than the aggregate of
>
> (i) its liabilities, and

> (ii) the amount that would be required to pay the holders of shares that have a right to be paid, on a redemption or in a liquidation, rateably with or prior to the holders of the shares to be purchased or redeemed.

Evidently, the Administrator equated redemption by the corporation with the right of retraction by the preferred shareholder. It agreed with Central Capital's position that once it became insolvent in December of 1991, Central Capital no longer had the ability to redeem the shares tendered for retraction and thus McCutcheon was restricted to exercising what rights it might have as a shareholder.

Facts as they relate to the claim of SYH

Pursuant to an Agreement of Purchase and Sale made as of June 30, 1989, as amended, Scottish & York Holdings Limited (the predecessor to SYH) sold to Central Capital the shares of Central Canada Insurance Services Limited, Eaton Insurance Company, Scottish & York Insurance Co. Limited and Victoria Insurance Company of Canada (collectively the "Insurance Companies"), except for certain preference shares held by the directors of those corporations. In consideration of this transfer, Central Capital issued to Scottish & York Holdings Limited 60,116,000 Series A Junior Preferred Shares and 9,618,560 Series B Junior Preferred Shares.

The Articles of Central Capital provided that it would pay on each dividend

payment date prior to the fifth anniversary of this issue, as and when declared by the directors out of the assets of the corporation properly applicable to the payment of dividends, a dividend of $.08 for each outstanding Series A Junior Preferred Share. The dividend was payable quarterly by the issuance of .02 Series B Junior Preferred Shares for every outstanding Series A Junior Preferred Share. No dividends were in fact declared.

The Articles also provided that Central Capital was obligated to retract the Series A Junior Preferred Shares and Series B Junior Preferred Shares, at the option of the holders of those shares, on the fifth anniversary of their issuance. The retraction price was $1.00 per share plus all accrued and unpaid dividends. Payment of the retraction price of these shares by Central Capital was subject to the provisions of the *CBCA,* which governs the affairs of Central Capital. For the purposes of this appeal, I believe that we can treat the balance of the provisions relating to these preferred shares as being the same as those governing the McCutcheon Series B Senior Preferred Shares.

Given that the operative date for proving claims against Central Capital was June 15, 1992, the retraction date governing the preferred shares of SYH was some two years removed. Notwithstanding, on September 8, 1992 SYH executed and delivered to the Administrator a Proof of Claim, a Counterpart of the Restated Subscription and Escrow Agreement, an initial Share Subscription and an Instrument of Claims Reduction Form, all

in the prescribed form and within the time required. The claim was that SYH was holding or entitled to hold the following shares of Central Capital:

(a) 60,116,000 Junior Preferred Series A shares;

(b) 9,618,560 Junior Preferred Series B shares;

(c) 4,611,095 Junior Preferred Series B shares accrued to June 15th, 1992 but not yet issued to SYH;

for a total of 74,345,655 shares, each having a retraction value of $1.00. However, because of some adjustments in favour of Central Capital to the purchase price of the shares sold by SYH to Central Capital under the June 30, 1989 Agreement of Purchase and Sale, the net claim as of June 15, 1992 was reduced from $74,345,655 to $72,388,836.

By Notice of Disallowance dated January 20, 1993, the Administrator disallowed the claim by SYH to subscribe for debentures and common shares to be issued by CIGL. The reasons for the disallowance are similar to those provided for disallowing the claims of McCutcheon. The Administrator found that SYH's right to require Central Capital to retract the Series A and B Junior Preferred Shares only arose on the expiry of the fifth anniversary of their issuance and that Central Capital was precluded from retracting those shares by virtue of its insolvency and the provisions of the *CBCA*. Hence SYH, like McCutcheon, was limited to exercising what other rights it might have as a shareholder.

Analysis

Although the factual groundwork is necessary for putting in perspective the sole issue before the court, the final question confronting us is a narrow one. Did the retraction clauses in the appellants' shares create a debt owed by Central Canada as of June 15, 1992 within the meaning of the *Bankruptcy Act*? I think that they did.

It is agreed that the operative section of the *Bankruptcy Act* is s.121(1). It reads as follows:

> 121. (1) All debts and liabilities, present or future, to which the bankrupt is subject at the date of the bankruptcy or to which he may become subject before his discharge by reason of any obligation incurred before the date of the bankruptcy shall be deemed to be claims provable in proceedings under this Act.

There was no bankruptcy in this case and thus the relevant date was agreed to be June 15, 1992. The obligations of Central Capital to the appellants were incurred before that date, and so the only question becomes whether the obligations created a debt between the appellants and Central Capital.

What then is a debt? All the parties turn to *Black's Law Dictionary*, quoting different editions. The following is from the Sixth Edition (1990), at p. 403:

> **Debt.** A sum of money due by certain and express agreement. A specified sum of money owing to one person from another, including not only the obligation of debtor to pay but right of creditor to receive and enforce payment....

> A fixed and certain obligation to pay money or some other valuable thing or things, either in the present or in the future.

The above is consistent with what is defined as a debt by *Jowitt's Dictionary of English Law*, 2nd ed. (1977), at p.562:

> A debt exists when a certain sum of money is owing from one person (the debtor) to another (the creditor). Hence "debt" is properly opposed to unliquidated damages; to liability, when used in the sense of an inchoate or contingent debt; and to certain obligations not enforceable by ordinary process. "Debt" denotes not only the obligation of the debtor to pay, but also the right of the creditor to receive and enforce payment.

And finally, *The Shorter Oxford Dictionary,* 3rd ed. (1973), at p. 497:

> **Debt** **1.** That which is owed or due; anything (as money, goods or service) which one person is under obligation to pay or render to another. **2.** A liability to pay or render something; the being under such liability.

I have no difficulty in finding that the claims of the appellants in the case under appeal fall within all of the above definitions. As will be discussed herein, concern was expressed in this case over whether or not the appellants as creditors were entitled to "receive and enforce payment" on the "debt" because of the insolvency of Central Capital on June 15, 1992. I will deal with the specific arguments relating to the effect of insolvency on this particular indebtedness in due course, but for the moment I am content to observe that the above definitions contemplate only that the creditor's right to recover is the reciprocal of the debtor's obligation to pay. For every debtor there must be a creditor. There may be cases where it is difficult to identify the person who in law may receive and enforce payment, but

this is not such a one.

With great respect to the judge of first instance and to the submissions of counsel for the unsecured creditors, I believe that the fundamental error that has been made in these proceedings arises from the conception that the preferred shares in question can either be debt instruments or equity participation instruments, but they cannot have the attributes of both. Feldman J. had this to say at p. 48 of her judgment:

> Although the right of retraction at the option of the preferred shareholder may be less common than the usual right of the company to redeem at its option, that right is one of the incidents or provisions attaching to the preferred shares, but does not change the nature of those shares from equity to debt. The parties have characterized the transaction as a share transaction. The court would require strong evidence that they did not intend that characterization in order to hold that they rather intended a loan.
>
> In my view, this case turns on whether the right of retraction itself creates a debt on the date the company becomes obligated to redeem even if it cannot actually redeem by payment on that date, or a contingent future debt on the same analysis, not on whether the preferred shares themselves with the right of retraction are actually debt documents.
>
> Because the preferred shares remain in place as shares until the actual redemption, the appellants are not creditors and have no claim provable under the *Bankruptcy Act* (Canada), and the appeals are therefore dismissed.

As I read these reasons, the learned judge is in effect stating that these instruments are preferred shares in the corporation because the parties have so described

them. In the first place, I do not think that describing the documents as preferred shares is conclusive as to what instrument the parties thought they were creating. In the second place, it is not what the parties call the documents that is determinative of their identity, but rather it is what the facts require the court to call them. The character of the instrument is revealed by the language creating it and the circumstances of its creation. Although these instruments may "remain in place as shares" until they are actually redeemed, they also contain a specific promise to pay at a specified date. This is the language of debt. I cannot accept the proposition that a corporate share certificate cannot create a corporate debt in addition to the certificate holder's rights as a shareholder.

The rules relating to the competing rights of shareholders and creditors of an insolvent corporation have become so regulated by governmental action that one can readily lose sight of the common law basis for making a distinction. To understand the difference in treatment, we must re-examine what a share of a corporation represents. Initially, a share is issued by the corporation to raise share capital. The price of the share is money or the promise of money. Accordingly, an individual share is one of a number of separate but integral parts of the authorized capital of a corporation. Even though it is the shareholders who contribute to the capital of the corporation, the capital remains the property of the corporation. The shareholders, however, as owners of the shares of capital, effectively control the corporation. They have the responsibility of managing its affairs through their

control over the board of directors and in popular terminology are considered to be the owners of the corporation. However, the corporation is a separate entity in law, and if in the course of carrying out its business it incurs debts to third parties, those debts are those of the corporation. A corporation is an intangible and its capital therefore represents its substance to third parties having business dealings with the corporation. A preferred share is simply a share of a class of issued shares which contains a preference over other classes of shares, whether preferred or common: see Sutherland, *Fraser and Stewart on Company Law of Canada*, 6th ed. (1993), at pp.157 and 195 for further discussion.

The rights of shareholders are conveniently summarized by R.M.Bryden in his chapter, "The Law of Dividends", contained in Ziegel ed., *Studies in Canadian Company Law* (1967), at p.270:

> The purchaser of a share in a business corporation acquires three basic rights: he is entitled to vote at shareholders' meetings; he is entitled to share in the profits of the company when these are declared as dividends in respect of the shares of the class of which his share forms a part; and he is entitled, upon the winding-up of the corporation, to participate in the distribution of the assets of the company that remain after creditors are paid. A fourth right which should be noted is the right to transfer ownership in his share, whereby the owner for the time being may realize upon the increase in value of the company's assets, or its favourable prospects, by selling his share at a price reflecting the buyer's estimation of the value of the rights he will acquire. Unless the shareholder chooses to sell his share, he can realize a return upon his investment only through receipt of dividends or by the return of his capital upon an authorized reduction of capital or winding up.

Shareholders are variously characterized as entrepreneurs, investors or risk-takers and as such they have the opportunities of benefitting from the successes of the corporation and suffering from its failures. While the corporation is an operating entity, the shareholders receive their rewards, if there are any, through the payment of dividends declared from time to time by the board of directors. While the source of these dividends is not restricted to surplus funds, the result of the payment of the dividend must not result in a return of capital to the shareholders. The classic justification for this rule was stated by Sir George Jessel, Master of the Rolls in *Flitcroft's Case* (1882), 21 Ch. D. 519 at 533-4:

> The creditor has no debtor but that impalpable thing the corporation, which has no property except the assets of the business. The creditor . . . gives credit to that capital, gives credit to the company on the faith of the representation that the capital shall be applied only for the purposes of the business, and he has therefore a right to say that the corporation shall keep its capital and not return it to the shareholders....

Creditors, on the other hand, do not have an ownership or equity interest in the corporation. They are third parties who have loaned money or otherwise advanced credit to the corporation. They look to the company for payment in accordance with the terms of the contract creating the indebtedness. They are also restricted in their recovery to the amounts stipulated in the terms of indebtedness. They are entitled to payment regardless of the financial circumstances of the debtor corporation and accordingly are not restricted to receiving payment of the debt from surplus. They can be paid out of assets or through the

creation of further indebtedness. It is immaterial how the corporation records this indebtedness in its internal books. In some circumstances the indebtedness could properly reflect the acquisition of property from a creditor as a capital asset. This does not, however, convert the creditor into an investor. The vendor of the property remains a creditor and retains priority over shareholders in the event of a bankruptcy or insolvency.

In my view, the reasons under appeal do not reflect a sensitivity to the circumstances which gave rise to the issuance of the preference shares. The shares were not issued by Central Capital to the general public in order to raise capital and do not represent an investment by the public in the capital of the corporation. They were issued to specific persons as payment for the acquisition of specified assets. While the corporation was authorized by its Articles of Incorporation to issue preferred shares generally, the shares issued to the appellants were structured to meet the requirements of the appellants as vendors of the controlling interest in the operating companies that Central Capital was acquiring. In my view, these preference shares are the equivalent of vendor shares in that the appellants received them in exchange for the transfer of assets to Central Capital.

In the case of McCutcheon, the retraction provision in the preferred shares represented only partial payment of an agreed value for the assets, but in the case of SYH, they represented the full value. In both cases, the agreed value as reflected in the retraction

price was guaranteed by Central Capital to be retractable at a fixed price at a predetermined date. By postponing the obligation to pay the purchase price in this way, Central Capital was using the retraction provisions of the preference shares as a vehicle for the financing of its expanding asset base. The appellants, for their part, deferred the realization of the purchase price of their assets to the agreed dates and thereby extended credit to the corporation. In return for extending credit for some or all of the selling price, the appellants agreed to receive dividends calculated in advance but payable as and when declared by the board of directors.

Thus, in looking at the substance of the transaction that led to the issuance of the preference shares, it appears to me that the retraction clauses were promises by Central Capital to pay fixed amounts on definite dates to the appellants. They evidenced a debt to the appellants. The fact that the appellants as holders of the preference shares had rights as shareholders in the corporation up to the time when the retraction clauses were exercisable did not affect their right to enforce payment of the retraction price when it became due.

The validity of an analysis directed to the substance of the transaction is supported by *Canada Deposit Insurance Corporation v. Canadian Commercial Bank*, [1992] 3 S.C.R. 558, a judgment of the Supreme Court of Canada delivered by Iacobucci J. The case involved a number of corporations constituting a support group which entered into an arrangement to provide emergency financial assistance to Canadian Commercial Bank

("CCB"). On the ultimate failure of the bank, the issue arose as to whether the monies advanced to CCB under this support arrangement were in the nature of a loan or in the nature of a capital investment. I find instructive to our situation Iacobucci J.'s observation at pp.590-1:

> As I see it, the fact that the transaction contains both debt and equity features does not, in itself, pose an insurmountable obstacle to characterizing the advance of $255 million. Instead of trying to pigeonhole the entire agreement between the Participants and CCB in one of two categories, I see nothing wrong in recognizing the arrangement for what it is, namely, one of a hybrid nature, combining elements of both debt and equity but which, in substance, reflects a debtor-creditor relationship. Financial and capital markets have been most creative in the variety of investments and securities that have been fashioned to meet the needs and interests of those who participate in those markets. It is not because an agreement has certain equity features that a court must either ignore these features as if they did not exist or characterize the transaction on the whole as an investment. There is an alternative. It is permissible, and often required, or desirable, for debt and equity to co-exist in a given financial transaction without altering the substance of the agreement. Furthermore, it does not follow that each and every aspect of such an agreement must be given the exact same weight when addressing a characterization issue. Again, it is not because there are equity features that it is necessarily an investment in capital. This is particularly true when, as here, the equity features are nothing more than supplementary to and not definitive of the essence of the transaction. When a court is searching for the substance of a particular transaction, it should not too easily be distracted by aspects which are, in reality, only incidental or secondary in nature to the main thrust of the agreement. [Emphasis in original.]

I have no difficulty in finding that the appellants' preferred shares with their

retraction clauses are of "a hybrid nature, combining elements of both debt and equity". As to the equity component, the appellants are shareholders prior to exercising their retraction rights in that they have the right to vote in certain circumstances and have a right to receive dividends when and if they are declared by the board of directors. The debt component is more significant however. The shares were not issued to investors, but to vendors of property. The vendors were entitled to receive a fixed sum at a specified time in payment therefor. Pending payment, the vendors were entitled to receive dividends which were the equivalent of interest on the unpaid balance.

I can think of no reason why the holders of these preferred shares should not be treated as both shareholders and creditors. It does not concern me that these appellants act as shareholders before their retraction rights are exercisable. Nor do I see any hardship to other creditors of Central Capital arising from the ability of these appellants to claim as creditors in the restructuring of the company given that the appellants are unpaid with respect to substantial assets sold to the corporation and now transferred on the restructuring to GIGL.

Much was made in argument of the fact that the retraction amounts could not be paid on the retraction dates. In the case of McCutcheon, the corporation was insolvent and subject to court administration on the due date of July 1, 1992. In the case of SYH, the retraction date did not arrive before the reorganization was complete.

The narrow issue of the effect of insolvency on a debt has been dealt with by the British Columbia Court of Appeal in *Re East Chilliwack Agricultural Co-Operative* (1989), 74 C.B.R. (N.S.) 1. In this case, the appellants were one-time members of three co-operative associations. The rules of the co-operatives permitted a member to withdraw upon written notice to the board of directors to that effect. The member was entitled to elect to have his shares redeemed either in equal instalments over five years or in one payment with interest at the end of five years. In April of 1987, the superintendent of co-operatives, under the authority of the *Cooperative Association Act*, R.S.B.C. 1979, c.66, suspended the co-operatives' right to redeem their shares until their financial situation was no longer impaired. The three co-operatives subsequently went bankrupt and a two-fold issue came before the bankruptcy court: (1) whether those members whose notices of withdrawal had been accepted by the board of directors but who had not yet received the value of the shares were entitled to rank as unsecured creditors, and (2) whether those who had delivered notices that had not been accepted were to be treated as unsecured creditors. The court of first instance found that the members were shareholders and answered both questions in the negative. That judge was reversed on appeal with the majority of the court deciding that the answer to both questions was yes. Hutcheon J.A. for the majority stated at p.13:

> I shall use Mr. Neels [a co-operative member] as my example. According to R. 3.06 he ceased to be a shareholder in May 1983. In May 1984 the Agricultural Co-operative owed him the first of five payments, or $686.40. I know of no principle of law that would support the proposition that Neels could not sue for that amount if the Agricultural Co-operative

> failed to pay in May 1984. Of course, the superintendent of co-operatives has power under s.15(2) to suspend payments if, in his opinion, the financial position of the co-operative was impaired. Subject to that power, the position of Neels and the Agricultural Co-operative would be that of ordinary creditor and debtor. In my opinion, the order made by the judge cannot be sustained on the first ground.

From this case, I extract the proposition that the fact of an insolvency, whether declared or not, does not change the nature of the relationship between debtor and creditor. It continues notwithstanding the inability of the debtor to pay or the creditor to collect.

It appears to me, with deference, that the issue of the effect of Central Capital's insolvency on the character of the retraction payments is something of a red herring. The contest in this appeal is between those who are conceded to be unsecured creditors and those whose claim to such status is contested. In both cases, any right to payment was suspended by Central Capital's announcement in December of 1991 that it was insolvent and that it had suspended all payments of principal and interest to unsecured creditors. This course of action was not freely chosen but was required by law. Any payments to creditors after the date of insolvency would be voidable at the instance of creditors on the basis that they were fraudulent preferences. In addition to ss.95 and 96 of the *Bankruptcy Act* dealing with fraudulent preferences generally, there is provincial legislation in the form of the *Fraudulent Conveyances Act*, R.S.O. 1990, c. F-29 and the *Assignments and Preferences Act*, R.S.O. 1990, c. A-33 that would be applicable. Counsel for the unsecured creditors maintains that

the right to redeem shares, including preference shares was postponed by s.36(2) of the *CBCA, supra.* I am not certain that s.36(2) applies to the retraction provisions of the appellants' preference shares as opposed to the redemption privileges of Central Capital, but in my opinion the point is irrelevant to this appeal. Once Cental Capital acknowledged its insolvency, it could neither redeem its shares nor honour its retraction obligations. The whole purpose for the creditors applying to the court for a stay of Central Capital's obligations, including those of the acknowledged unsecured creditors, was to arrange for a scheme of payments to all creditors that could not be subject to attack as preferences. There is no suggestion on the evidence before us that the claims of unsecured creditors accepted by the Administrator were claims that had crystallized prior to the insolvency of Central Capital. Nor is it suggested that any creditors were rejected because some or all of their claims were not payable until after the date of the insolvency. The fact of insolvency, by itself, does not provide a rational basis for distinguishing the claims of the appellants from those of other unsecured creditors.

Much also was made of the provision in the Articles authorizing the shares in question, which states that if the obligation to redeem "would be contrary to applicable law", then Central Capital "shall redeem only the maximum number of [shares] it is then permitted to redeem". Counsel for the unsecured creditors submits that the reference to "applicable law" is to s.36 of the *CBCA*. The reference certainly embraces the *CBCA*, but it is not

restricted by its terms to that statute. For example, "applicable law" would also capture s.101 of the *Bankruptcy Act*, which provides for penalties against directors and shareholders where insolvent companies redeem shares or pay dividends.

There was no evidence led as to why this provision was placed in the Articles and the share certificates. It appears to be a standard clause in all the preference shares issued by the corporation and not just those that were adapted to the appellants' situations where specific retraction clauses were drafted to satisfy the particular asset acquisitions. For my part, I have difficulty in understanding how a consideration of this provision assists the process of determining the underlying character of the retraction obligations. The statement is so self-evident that it is almost banal. I can only assume that the statement was included in the share provisions of a corporation marketing its securities world-wide so as to inform purchasers that legal restrictions in this jurisdiction apply to the company's right to redeem shares.

In summary then regarding the insolvency argument, these various statutes prohibit payments of any kind to shareholders by an insolvent company. As I understand it, counsel does not question that when a dividend has been lawfully declared by a corporation, it is a debt of the corporation and each shareholder is entitled to sue the corporation for his proportion: see *Fraser and Stewart, supra,* at p.220 for a list of

authorities. However, once a company is insolvent it cannot make payments to shareholders or creditors so long as it continues to be insolvent. On the other hand, nowhere in the *CBCA* or elsewhere will we find authority for the proposition that once a corporation is insolvent, it is no longer obliged to pay its debts. The obligation is postponed until the insolvency is corrected or the corporation makes an accommodation with its creditors and obtains a release with or without the assistance of the various statues dealing with insolvency.

The existence of provisions prohibiting payment to shareholders and creditors on insolvency does not in anyway assist the determination of whether the retraction obligations at issue in this appeal constitute a debt or a return of capital at the time they are payable. Speaking of the obligation to honour the retraction in terms of the corporation redeeming its shares also introduces the wrong emphasis. The corporation is not redeeming the shares at its option as contemplated by most redemptions. It is being forced to redeem them because of a prior contractual obligation for which the preferred shareholder gave good consideration. It is for this reason that I question whether s.36 of the *CBCA* is the appropriate reference point. This is not the type of payment which concerned Jessel M.R in *Flitcroft's Case, supra.*

At the risk of oversimplifying this case, it appears to me that many of the arguments made against the appellants' claims to be creditors of Central Capital are

impermissible in the context of the Agreed Statement of Facts. The issue in appeal is frozen in time by the stipulation that the court is to determine if these retraction clauses created a debt within the meaning of the *Bankruptcy Act* on June 15, 1992. The arguments against the appellants' claims also ignore that debts under s.121(1) of the *Bankruptcy Act* need not be payable at the date of the bankruptcy (or June 15, 1992 in our scenario). They need only come beneath the broad umbrella of "debts and liabilities, present and future, to which [Central Capital] is subject" on June 15, 1992. The fact that the debts could not be paid after June 15, 1992, does not mean that they were not provable claims pursuant to s.121 of the *Bankruptcy Act*. Moreover, assuming the retraction clauses created a debt payable on a future date, neither the order of Houlden J. nor the restrictions in the Articles creating the shares themselves purported to extinguish that debt.

There is nothing in either the Articles of Central Capital or in the law that excuses the obligation to pay the retraction amounts. Rather, discharge of the obligation is simply postponed until the cessation of the disabling event of insolvency. Article 4.3 of the Senior Series B Provisions provides the mechanism for future redemption of tendered shares that are not redeemed because such redemption would be contrary to law. Article 4.5 provides that the inability to effect a redemption does not affect the obligation to pay dividends accrued or accruing on the unredeemed shares.

So far as SYH is concerned, the retraction price was not payable until the fifth anniversary of the June 1989 sale of assets. Therefore, no issue of the effect of insolvency arose in 1992. The orders of Houlden J. of June 15 and July 9, 1992 changed the rules of the game. If this appellant is a creditor, it does not have to wait until the retraction date. It can claim as a creditor now. It did and the claim was disallowed. However, if this court holds that the claim should have been allowed, then in accordance with the narrow issue put to us, SYH is entitled to be accepted as a full creditor in the entire reorganization of Central Capital.

An additional factor raised by counsel during argument was that Article 7, *supra*, provides that in the event of the liquidation, dissolution or winding-up of Central Capital, whether voluntary or involuntary, or any other distribution of assets among its shareholders for the purpose of winding up its affairs, the holders of these preferred shares are entitled to recover "from the assets of Central Capital" the retraction price plus all accrued and unpaid dividends thereon. Such amount is to be paid prior to payment to junior ranking shareholders. The Article further provides that "[u]pon payment of such amounts, the holders of [the preferred shares] shall not be entitled to share in any further distribution of assets of [Central Capital]". Because it is trite law that shareholders are entitled to recover from assets only after all ordinary creditors have been paid in full, counsel for the unsecured creditors submits that the fact that the clause contemplates priorities between shareholders

on a winding up or a liquidation of assets is clear evidence that they were shareholders only.

I have two responses to this submission. The first is the obvious, that we are not dealing with this contemplated event. We are dealing with a reorganization in which the parties have put a single question to the court: are the appellants creditors? Consideration of issues of priority or the valuation of claims have been taken away by the narrow scope of the agreed question. If the answer to the question posed is yes, then in accordance with the Agreed Statement of Facts, the appellants are entitled to have their claims as creditors allowed under the Subscription and Escrow Agreement and to participate in the Amended Plan of Arrangement as Senior Creditors. If the answer is no, they are to be treated as the Administrator has treated them: they are not creditors at all and are restricted to receiving Central New Common Shares under the Amended Plan of Arrangement.

My second response is that counsel for the unsecured creditors misses the significance of the clause. He assumes that there will be a deficiency in all circumstances leading up to a liquidation, dissolution or winding up that will necessitate a *pro rata* distribution, first to creditors and then to shareholders of all classes. However, the clause does not say that those with retraction rights are not creditors. It says that the retraction amounts are to be paid out of assets, not suplus. Once the retraction amounts have been paid in full, the appellants are not entitled to share in any further distribution. This contemplates

a surplus after all creditors, including the appellants, have been paid in full. Accordingly, far from classifying the appellants as shareholders, the clause provides that they are not entitled to be treated as shareholders under a winding up or liquidation but only as creditors.

Finally, with respect to SYH's claims, it was submitted that these claims were so contingent as to be virtually non-existent. The claims anticipate a retraction date that as of June 15, 1992 was some two years into the future. Upon approval of the Amended Plan of Arrangement on December 18, 1992, the shares of SYH were cancelled and replaced by a new issue of shares, the Central New Common Shares. Counsel relied upon the finding of Feldman J. that there was then no discernable basis upon which the retraction could occur. Once again, with respect, this conclusion misses the point. Following the final order of Houlden J. approving the Amended Plan of Arrangement, all the shares *and* all the debts of Central Capital disappeared. There was thereafter no discernable basis upon which any event contemplated by any debt or share instruments could occur. We are only concerned with the status of shareholders and creditors as of June 15, 1992.

Based on the reasons set out above, I have concluded that the retraction amounts do fall within the definition of debts and liabilities, present or future, to which Central Capital was subject on June 15, 1992. This does not apply to undeclared dividends however, because until a dividend is declared no action on behalf of a shareholder lies to

enforce its payment: see *Fairhall v. Butler,* [1928] S.C.R. 369 at 374. If undeclared dividends have been claimed by any of the appellants they should be disallowed. In all other respects the claims should be allowed.

Accordingly, I would allow the appeals, set aside the order of Feldman J. and order that the appellants have provable claims that are to be allowed by the Administrator. The record does not disclose what order if any Feldman J. made as to costs. Certainly the appellants are entitled to their costs of this appeal. If the parties are unable to agree with respect to any other disposition of costs, I would suggest that they submit their positions to the court in writing.

LASKIN J.A. (CONCURRING):

I have read the reasons of my colleagues Justice Finlayson and Justice Weiler. Like Justice Weiler, I would affirm the decision of the motions judge, Feldman J., and dismiss these appeals. I prefer, however, to state my own reasons for upholding the position of the unsecured creditors of Central Capital Corporation.

The Issue

The application was argued before Madam Justice Feldman on an agreed statement of facts. My colleagues have summarized the relevant facts and important provisions of the documents. Each appellant holds preferred shares of Central Capital and each appellant's shares contain a right of retraction — a right to require Central Capital to redeem the shares on a fixed date and for a fixed price. The retraction date for the appellants James McCutcheon and Central Guarantee Trust Company (collectively McCutcheon) was July 1, 1992, and before that date McCutcheon exercised his right of retraction and tendered his shares for redemption. The retraction date for the appellant S.Y.H. Corporation was September 1994 and although it could not tender its shares for redemption, it did file a proof of claim with the Administrator of Central Capital. The Administrator disallowed each appellant's claim and Feldman J. dismissed appeals from the Administrator's decisions.

The issue on these appeals is whether McCutcheon and S.Y.H. Corporation "have claims provable against Central Capital Corporation within the meaning of the *Bankruptcy Act (Canada)* as amended as of the date of the Restated Subscription and Escrow Agreement." Under the *Bankruptcy Act,* R.S.C. 1985, c.B-3, s.2, a claim provable "includes any claim or liability provable in proceedings under this Act by a creditor" and a creditor "means a person having a claim, preferred, secured or unsecured, provable as a claim under this Act." Section 121(1) of the *Bankruptcy Act* further defines claims provable as follows:

> 121.(1) All debts and liabilities, present or future, to which the bankrupt is subject at the date of the bankruptcy or to which he may become subject before his discharge by reason of any obligation incurred before the date of the bankruptcy shall be deemed to be claims provable in proceedings under this Act.

The date of the Restated Subscription and Escrow Agreement is May 1992.[1] By then, and indeed since December 1991, Central Capital had been insolvent and therefore was prohibited by s.36(2) of the *Canada Business Corporations Act*, R.S.C. 1985, c.C-44 from making any payment to redeem the appellants' shares.

On June 15, 1992, Houlden J. provided that Central Capital could be reorganized under the *Companies' Creditors Arrangement Act,* R.S.C. 1985, c.C-36 and he stayed proceedings against it. Houlden J.'s order of July 9, 1992, which approved the restructuring of Central Capital, was made without prejudice to the right of the appellants to assert claims as creditors. Thus the question for this court is whether the appellants' retraction rights created debts of Central Capital in May, 1992. In other words were McCutcheon and S.Y.H. Corporation creditors of Central Capital in May, 1992? If they were creditors, then like the other unsecured creditors of Central Capital, they can elect to take

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[1] There is a discrepancy in the materials before this court on the relevant date for establishing a claim provable against Central Capital: S.Y.H. Corporation used May, 1992, the date of the Restated Subscription and Escrow Agreement whereas McCutcheon and the unsecured creditors of Central Capital Corporation used June 15, 1992, the date of the court-ordered stay of proceedings against Central Capital. I have used the May 1992 date but nothing turns on the use of this date as opposed to the June 15, 1992 date.

shares in the newly incorporated company, Canadian Insurance Group Limited; if they were not creditors, then they remain shareholders of Central Capital under the restructuring plan.

This is a question of characterization. I will address the question first, by considering the "substance" of the relationship between each appellant and the company; and second by considering s.36(2) of the *Canada Business Corporations Act, supra.* In brief I conclude:

(1) Although the relationship between each appellant and the company has characteristics of debt and equity, in substance both McCutcheon and S.Y.H. Corporation are shareholders, not creditors of Central Capital. Neither the existence of their retraction rights nor the exercise of those rights converts them into creditors;

(2) Finding that the appellants were creditors of Central Capital would defeat the purpose of s.36(2) of the statute.

I The Relationship Between the Appellants and Central Capital

Preferred shares have been called "compromise securities" and even "financial mongrels": Grover and Ross, Materials and Corporate Finance (1975), at p.49. Invariably

the conditions attaching to preferred shares contain attributes of equity and, at least in an economic sense, attributes of debt. Over the years financiers and corporate lawyers have blurred the distinction between equity and debt by endowing preferred shareholders with rights analogous to the rights of creditors. One example is the right of redemption — the right of the corporation to compel preferred shareholders to sell their shares back to the corporation. Another example, and it is the case before us, is the right of retraction — the right of shareholders to compel the corporation to buy back their shares on a specific date for a specific price.

I acknowledge, therefore, that redeemable or retractable preferred shares are somewhat different from conventional equity capital. What makes the appeals before us difficult is that although the appellants appear to hold equity, their right of retraction appears to be a basic characteristic of a debtor-creditor relationship. See Grover and Ross, *supra,* at pp.47-49; Buckley, Gillen and Yalden, Corporations: Principles and Policies, 3rd ed. (1995), at pp.938-940.

If the certificate or instrument contains features of both equity and debt — in other words if it is hybrid in character — then the Court must determine the "substance" of the relationship between the holder of the certificate and the company. This is the lesson of Justice Iacobucci's judgment in *Canada Deposit Insurance Corporation v. Canadian*

Commercial Bank, [1992] 3 S.C.R. 558. In that case the Supreme Court of Canada had to determine whether the financial assistance given by several lending institutions to try to rescue the Canadian Commercial Bank was "in the nature of a loan" or "in the nature of a capital investment." Justice Iacobucci discussed his approach to the problem at pp.590-591 of his judgment:

> As I see it, the fact that the transaction contains both debt and equity features does not, in itself, pose an insurmountable obstacle to characterizing the advance of $255 million. Instead of trying to pigeonhole the entire agreement between the Participants and CCB in one of two categories, I see nothing wrong in recognizing the arrangement for what it is, namely, one of a hybrid nature, combining elements of both debt and equity but which, in substance, reflects a debtor-creditor relationship. Financial and capital markets have been most creative in the variety of investments and securities that have been fashioned to meet the needs and interests of those who participate in those markets. It is not because an agreement has certain equity features that a court must either ignore these features as if they did not exist or characterize the transaction on the whole as an investment. There is an alternative. It is permissible, and often required, or desirable, for debt and equity to co-exist in a given financial transaction without altering the substance of the agreement. Furthermore, it does not follow that each and every aspect of such an agreement must be given the exact same weight when addressing a characterization issue. Again, it is not because there are equity features that it is necessarily an investment in capital. This is particularly true when, as here, the equity features are nothing more than supplementary to and not definitive of the essence of the transaction. When a court is searching for the substance of a particular transaction, it should not too easily be distracted by aspects which are, in reality, only incidental or secondary in nature to the main thrust of the agreement.

In determining the substance of the relationship, as in any other case of contract interpretation, the court looks to what the parties intended. In *CDIC v. CCB, supra,* Iacobucci J. put this proposition as follows at p.588:

> As in any case involving contractual interpretation, the characterization issue facing this Court must be decided by determining the intention of the parties to the support agreements. This task, perplexing as it sometimes proves to be, depends primarily on the meaning of the words chosen by the parties to reflect their intention. When the words alone are insufficient to reach a conclusion as to the true nature of the agreement, or when outside support for a particular characterization is required, a consideration of admissible surrounding circumstances may be appropriate.

In these appeals what the parties intended is reflected mainly in the share purchase agreements and the conditions attaching to the appellants' shares, but also in the articles of incorporation and in the way Central Capital recorded the appellants' shares in its financial statements. These documents indicate that in substance the appellants are shareholders of Central Capital, not creditors. I rely on the following considerations to support my conclusion:

(i) Both appellants agreed to take preferred shares instead of some other instrument — for example, a bond or debenture — that would obviously have made them

creditors. The appellant McCutcheon sold shares of one corporation (Canadian General Securities Limited) for cash and for shares of another corporation (Central Capital). Neither the share purchase agreements nor the share conditions support McCutcheon's contention that in taking preferred shares he was extending credit to Central Capital by deferring payment of the purchase price. He made an investment in the capital of Central Capital, no doubt because of the attractive dividend rate, the income tax advantages of preferred shares and "sweeteners" such as conversion privileges. Unlike Finlayson J.A., I place little weight on what he termed "the unique nature of the transaction". McCutcheon transferred assets to acquire his preferred shares rather than acquiring them with cash. But he nonetheless decided to invest in Central Capital and to take the risk and the profits (through dividends) of his investment.

Similarly, S.Y.H. Corporation exchanged its equity investment in four insurance companies for an equity investment in Central Capital. It too chose equity not debt. None of the contractual documents indicates that the appellants' retraction rights were intended to trigger an obligation on the part of Central Capital to repay a loan. Moreover, as Weiler J.A. points out, neither the share purchase agreements nor the share conditions provides for interest if Central Capital fails to honour its retraction obligations.

(ii) The senior preferred shares and junior preferred shares that the appellants own

were part of the authorized capital of Central Capital before the appellants acquired them.

(iii) The appellants' shares were recorded in the financial statements of Central Capital as "capital stock," along with the company's issued and outstanding common shares, class "A" shares and warrants. The amount Central Capital might be obligated to pay the appellants if they exercised their retraction rights was not recorded as debt (even contingent debt) in the company's financial statements.

(iv) Both appellants had the right to receive dividends on their shares and McCutcheon had the right to vote his shares for the election of directors of Central Capital if dividends remained unpaid for a specified time. These rights — to receive dividends and to vote — are well recognized rights of shareholders. And these rights continue, even after the retraction dates, until the appellants' shares are redeemed.

(v) The preferred share conditions provide that on a liquidation, dissolution or winding up, the holders rank with other shareholders and therefore, implicitly, behind creditors. The appellant McCutcheon, who holds senior preferred shares, would rank behind creditors but ahead of the holders of subordinate classes of shares; the appellant S.Y.H. Corporation, which holds junior preferred shares, would rank behind senior preferred shareholders but ahead of common shareholders.

These provisions in the preferred share conditions also state that on payment of the amount owing to them the appellants "shall not be entitled to share in any further distribution of assets of the corporation." Finlayson J.A. interprets this to mean that the appellants "are not entitled to be treated as shareholders under a winding up or liquidation but only as creditors." I disagree. These are typical preferred share provisions, which limit the recovery of the holders but do not treat them as creditors: *Sutherland et al.,* Fraser & Stewart Company Law of Canada, 6th ed. (1993), at p.198. At least on a liquidation, dissolution or winding up, the preferred share conditions evidence that the appellants would be treated not as creditors but as shareholders. In *CDIC v. CCB, supra,* Iacobucci J. placed considerable weight on a provision in the Participation Agreement stating that each participant "shall rank *pari passu* with the rights of the depositors." No such provision exists in this case. Indeed the share conditions I have referred to state the opposite.

Of course, Central Capital was reorganized, not liquidated, dissolved or wound up and the preferred share conditions are silent about what occurs on a reorganization. Still these conditions shed light on what the parties intended on the reorganization. Section 12(1) of the *Companies' Creditors Arrangement Act, supra,* defines claim as "any indebtedness, liability or obligation of any kind that, if unsecured would be a debt provable in bankruptcy within the meaning of the *Bankruptcy Act.*" The question the court has been asked to answer is the same question that would arise on a liquidation. It is illogical to conclude that the

appellants could claim only as shareholders on a liquidation and yet can claim as creditors on the reorganization. Whether Central Capital's financial difficulties led to a liquidation or a reorganization, the issue is the same and the analysis and the result should also be the same.

The appellants argue, however, that they are shareholders only until they exercise their retraction rights but once they exercise these rights they become creditors. I do not agree with this argument. The share conditions provide that even after exercising their retraction rights, the appellants continue to be entitled to dividends and to vote until their shares are redeemed. In other words, they continue to enjoy the rights of shareholders. Moreover, if when the appellants exercised their retraction rights the company were insolvent and were to be subsequently liquidated (or dissolved or wound up), the appellants would rank as shareholders on the liquidation. And as I have indicated above the result should be no different on the reorganization.

It seems to me that these appellants must be either shareholders or creditors. Except for declared dividends, they cannot be both. Once they are characterized as shareholders, their rights of retraction do not create a debtor-creditor relationship. These rights enable them to call for the repayment of their capital on a specific date (and at an agreed upon price) provided the company is solvent. Ordinarily shareholders have to recoup

their investment by selling their shares to third parties. If they have retraction rights, however, they can compel the company (if solvent) to repay their investment at a given time for a given price. But the right of retraction provides for the return of capital not for the repayment of a loan. Certainly the *Canada Business Corporations Act* treats a redemption of shares as a return of capital because s.39 of the statute requires a company on a redemption to deduct from its stated capital account an amount equal to the value of the shares redeemed. The shares redeemed are then either cancelled or returned to the status of authorized but unissued shares.

Putting it differently, a preferred shareholder exercising a right of retraction on the terms that exist here must rank behind the company's creditors. Grover and Ross make this point more generally in their Materials and Corporate Finance, *supra,* at pp.48-49:

> On the other hand, the company cannot issue "secured" preferred shares in the sense that shares cannot have a right to a return of capital which is equal or superior to the rights of creditors. Preferred shareholders are risk-takers who are required to invest capital in the business and who can look only to what is left after creditors are fully provided for. Thus, in the absence of statutory authorization, the claims of shareholders cannot be secured by a lien on the corporate assets. They rank behind creditors but before common shareholders (if specified) on a voluntary or involuntary dissolution of the company.

Admittedly there is little authority in Canada on the issue confronting this

court. Some of the cases that the respondent relies on — for example, *Re Patricia Appliance Shops Ltd.*, [1923] 3 D.L.R. 1160 (Ont. S.C.), *Laronge Realty Ltd. v. Golconda Investments Ltd.* (1986), 63 C.B.R. 74 (B.C.C.A.) and even *Re Meade,* [1951] 2 All E.R. 168 — are of limited assistance because the shareholders in those cases did not have retraction rights.

Perhaps the closest case — and the appellants rely heavily on it — is the judgment of the British Columbia Court of Appeal in *Re East Chilliwack Agricultural Co-operative* (1989), 74 C.B.R. (N.S.) 1. In that case a majority of the court (Craig J.A. dissenting) held that a withdrawing member of a co-operative association who elected to have his shares redeemed in instalments over a five-year period should be treated on the subsequent bankruptcy of the association as an ordinary creditor rather than as a shareholder. I decline to apply *East Chilliwack* for three reasons. First, because the case was decided in 1989, the British Columbia Court of Appeal did not have the benefit of the Supreme Court of Canada's reasons in *CDIC v. CCB, supra.* In *East Chilliwack* Hutcheon J.A., writing for the majority did not focus on what the parties intended when the member contracted with the co-operative. Instead he only considered the relationship between the member and the co-operative after the member had withdrawn. I do not think his approach is consistent with Justice Iacobucci's judgment in *CDIC v. CCB, supra.*

Second, there are important factual differences between *East Chilliwack* and

the appeals before us. Justice Weiler has referred to these factual differences in her reasons. The most important of these differences are the following; in *East Chilliwack* the rules of the association provided that a member had to withdraw from the association to trigger the right of redemption, whereas the appellants' share conditions provide that they continue to be shareholders of Central Capital until their shares are redeemed; in *East Chilliwack* the member elected to withdraw and redeem his shares when the association was solvent whereas when the appellant McCutcheon exercised his right of retraction Central Capital was insolvent; and in *East Chilliwack* Hutcheon J.A. expressly stated that he was not considering the effect of the superintendent's power to suspend payments if the financial position of the co-operative was impaired, whereas the effect of the statutory prohibition against Central Capital making payment, found in s.36(2) of the *Canada Business Corporations Act*, is in issue in these appeals.

Third, the decision in *East Chilliwack* is at odds with most of the American case law and I favour the American approach. When a company repurchases shares by instalment and bankruptcy intervenes, the prevailing American position is that the shareholder's claim is deferred to the claims of ordinary creditors. The decision of the Fifth Circuit Court of Appeals in *Robinson v. Wangemann* 75 F.2d 756 (1935) is frequently cited. The facts of that case are virtually identical to the facts in *East Chilliwack*. A company had agreed to repurchase a stockholder's stock by instalments. Although the company was

solvent when the agreement was made it went bankrupt before the repurchase was completed. The stockholder sought to prove as an ordinary creditor for the unpaid purchase price. Foster, Circuit Judge, writing for a unanimous court rejected the stockholder's claim at p.757:

> A transaction by which a corporation acquires its own stock from a stockholder for a sum of money is not really a sale. The corporation does not acquire anything of value equivalent to the depletion of its assets, if the stock is held in the treasury, as in this case. It is simply a method of distributing a proportion of the assets to the stockholder. The assets of a corporation are the common pledge of its creditors, and stockholders are not entitled to receive any part of them unless creditors are paid in full. When such a transaction is had, regardless of the good faith of the parties, it is essential to its validity that there be sufficient surplus to retire the stock, without prejudice to creditors, at the time payment is made out of assets.

At the heart of *Robinson v. Wangemann* is the finding that the selling stockholder is not a creditor in the sense of a person who loans money to a corporation, and therefore is not entitled to parity with the general creditors. The principle in *Robinson v. Wangemann* seeks to protect creditors by refusing to permit selling stockholders, who were risk investors, to withdraw their capital on the same terms as general creditors in the event of insolvency. Section 40(3) of the *Canada Business Corporations Act* — a section to which I shall return when considering s.36(2) of the same statute — codifies the principle in *Robinson v. Wangemann* for share repurchases, though not for share redemptions. See

also Blumberg, The Law of Corporate Groups (1989), at pp.205-210 and see *contra Wolff v. Heidritter Lumber Co.* 163 A. 140 N.J.Ch. (1932).

Quite apart from the instalment purchase price cases, American courts have often grappled with the question whether preferred stockholders can claim as creditors of the corporation. Although there are cases going both ways, most appear to come to the same conclusion as I do. The American cases are collected in Bjor and Solheim, Fletcher Cyclopedia Of the Law of Private Corporations (1995), revised vol. 11 and in Bjor and Reinholtz, Fletcher Cyclopedia Of the Law of Private Corporations (1990), revised vol. 15A. In volume 11 the authors of the text indicate — as did the Supreme Court of Canada in *CDIC v. CCB* — that "[w]hether or not the holder of a particular instrument or certificate is to be regarded as a shareholder or a creditor is a question of interpretation, and depends on the terms of the contract as evidenced by the instrument, the articles of incorporation, and the statutes of the state. The nature of the transaction is to be determined by the real substance and effect of the contract rather than by the name given to the obligations or its form ..." (at p.566).

And in volume 15A the authors state at pp.290 and 292 that even the arrival of a fixed redemption date does not change a preferred stockholder into a creditor:

> Holders of preferred stock of a corporation, in the absence of express provision to the contrary, are stockholders and not creditors of the corporation, except for dividends declared. They have no lien upon, and are not entitled to, any of the assets of the corporation when it becomes insolvent, until all debts are paid. Furthermore, there is authority that the status of a preferred stockholder is not changed to that of creditor, even though a dividend is guaranteed. Indeed it is beyond the power of a corporation to issue a class of stock, the holders of which are entitled to preference over general creditors.
>
> ...
>
> Even where preferred stock has a fixed redemption date, arrival of that date does not change the status of a preferred stockholder to that of a creditor. (pp.290, 292)

I agree with these statements. I therefore conclude first that the appellants, in substance, were shareholders of Central Capital not creditors; and second that neither the existence nor the exercise of their retraction rights turned them into creditors.

II Provable Claims and Section 36(2) of the *Canada Business Corporations Act*

In May 1992 Central Capital was insolvent. It was unable to pay its liabilities as they became due and the realizable value of its assets was less than the aggregate of its liabilities. Because it was insolvent it was prohibited by s.36(2) of the *Canada Business Corporations Act* from redeeming the appellants' shares. Section 36(2) of the statute provides:

> 36. (2) A corporation shall not make any payment to purchase or redeem any redeemable shares issued by it if there are reasonable grounds for believing that
>
> (a) the corporation is, or would after the payment be, unable to pay its liabilities as they become due; or
>
> (b) the realizable value of the corporation's assets would after the payment be less than the aggregate of
>
> (i) its liabilities, and
>
> (ii) the amount that would be required to pay the holders of shares that have a right to be paid, on a redemption or in a liquidation, rateably with or prior to the holders of the shares to be purchased or redeemed.

As well, the appellants' share conditions provide that they are not permitted to redeem their shares if to do so would be "contrary to applicable law," in this case s.36(2) of the statute.

To hold that the appellants have provable claims would defeat the purpose of s.36(2) of the *Canada Business Corporations Act*. At common law a company could not repurchase its own shares on the open market or in the language of *Trevor v. Whitworth* (1887), 12 A.C. 409, a company could not "traffick in its own shares." The obvious reason was to prevent companies from using their assets to destroy the claims of their creditors. Modern corporate statutes, such as the *Canada Business Corporations Act,* modified the rule

in *Trevor v. Whitworth* to permit repurchases provided the company's creditors would not be prejudiced. Thus the legislation insisted that the company could not repurchase its own shares unless it satisfied stated solvency tests. And so, s.34(2) of the *Canada Business Corporations Act* provides:

> 34. (2) A corporation shall not make any payment to purchase or otherwise acquire shares issued by it if there are reasonable grounds for believing that
>
> (a) the corporation is, or would after the payment be, unable to pay its liabilities as they become due; or
>
> (b) the realizable value of the corporation's assets would after the payment be less than the aggregate of its liabilities and stated capital of all classes.

In *Nelson v. Rentown Enterprises Inc.* (1993), 96 D.L.R. (4th) 586 aff'd (1994), 109 D.L.R. (4th) 608 (Alta. C.A.), Hunt J. of the Alberta Queen's Bench wrote at p.589:

> The policy behind the s.34(2) limitation upon a corporation's power to purchase its own shares seems obvious. It is intended to ensure that one or more shareholders in a corporation do not recoup their investments to the detriment of creditors and other shareholders. It has been observed that:
>
> > Corporate power to purchase its own stock has been frequently abused. Done by corporations conducting faltering businesses, it has been employed to create preferences to the detriment of creditors and of the other stockholders.

(*Mountain State Steel Foundries, Inc. v. C.I.R., supra, at p. 741* [284 F.2d 737 (1960)].)

> Modern business statues permit these share purchases to take place provided that the position of creditors and other shareholders is protected, by virtue of the application of the s.34(2) tests.

Redemptions of preferred shares, unlike repurchases, were always permitted at common law as long as they were not made in contemplation of bankruptcy. But the solvency test in s.36(2) of the *Canada Business Corporations Act* has the same purpose as the solvency test in s.34(2): to prevent redemptions if they would allow the company to prejudice the claims of creditors. See Buckley *et al.*, Corporations: Principles and Policies, *supra,* at pp.968-71. To hold that the appellants' retraction rights gave rise to provable claims in the face of s.36(2), thereby allowing the appellants to rank equally with the unsecured creditors, would undermine the purpose of the section. If a claim in a bankruptcy or reorganization proceeding is unenforceable under the statute, the claim is not entitled to recognition on a parity with the claims of unsecured creditors: See *Blumberg, supra,* at pp.205-6; and *Farm Credit Corporation v. Holowach (Trustee of)* (1988), 68 C.B.R. (N.S.) 255 (Alta. C.A.).

I draw comfort in this conclusion from s.40 of the *Canada Business Corporations Act.* Section 40(1) provides that a contract with a corporation for the purchase

of its shares is specifically enforceable against the corporation "except to the extent that the corporation cannot perform the contract without thereby being in breach of s.34 ..." Section 40(3) then states:

> 40.(3) Until the corporation has fully performed a contract referred to in subsection (1), the other party retains the status of a claimant entitled to be paid as soon as the corporation is lawfully able to do so or, in a liquidation, to be ranked subordinate to the rights of creditors but in priority to the shareholders.

In other words, the section recognizes that if a company contracts to repurchase its shares but is prohibited from doing so because it is insolvent, the vendor of the shares is not a creditor and on a liquidation ranks subordinate to the rights of creditors. The shareholder cannot be repaid at the expense of the company's creditors. Although s.40 does not expressly apply to s.36, I think that the rationale for s.40(3) applies to redemptions as well as to repurchases. Whether a repurchase or a redemption, the shareholder is not a creditor and is subordinate to the rights of creditors. More simply the shareholder does not have a provable claim.

The appellants rely on *The Custodian v. Blucher,* [1927] 3 D.L.R. 40, (S.C.C.) but in my view this case does not assist them. In *Blucher* dividends were declared on stock but payment of the dividends was suspended during World War I. The Supreme

Court of Canada held at p.43 that "[t]he right of recovery was in suspense during the war, but the debt nevertheless existed." In that case, however, the dividend was declared before the suspension of payment took place. Moreover, as Justice Finlayson points out in his reasons, courts have always accepted the proposition that when a dividend is declared it is a debt on which each shareholder can sue the corporation.

Holding that the appellants do not have provable claims accords with sound corporate policy. On the insolvency of a company the claims of creditors have always ranked ahead of the claims of shareholders for the return of their capital. Case law and statute law protect creditors by preventing companies from using their funds to prejudice creditors' chances of repayment. Creditors rely on these protections in making loans to companies. Permitting preferred shareholders to be turned into creditors by endowing their shares with retraction rights runs contrary to this policy of creditor protection.

I would dismiss these appeals. I would not make any cost order. I am grateful to all counsel for their assistance on this interesting and difficult problem.

WEILER J.A.:

I have had the benefit of reading the reasons of Finlayson J.A. and for the reasons which follow I respectfully disagree with his conclusion that the appellants are entitled to prove a claim pursuant to the *Companies' Creditors Arrangement Act,* R.S.C. 1985, c. C-36 (the "*CCAA*").

Section 12(1) of the *CCAA* requires that persons wishing to participate in a reorganization have claims which would be provable in bankruptcy. Section 121(1) of the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, states that "[a]ll debts and liabilities, present or future ... shall be deemed to be claims provable in proceedings under this Act."

In order to decide whether the obligation of Central Capital to redeem the preferred shares of the appellants is a claim provable in bankruptcy, it is necessary to characterize the true nature of the transaction. The court must look to the surrounding circumstances to determine whether the true nature of the relationship is that of a shareholder who has equity in the company or whether it is that of a creditor owed a debt or liability by the company: *Canada Deposit Insurance Corp. v. Canadian Commercial Bank,* [1992] 3 S.C.R. 558. In this case, the decision is not an easy one. Where, as here, the agreements between the parties are reflected in the articles of the corporation, it is

necessary to examine them carefully to characterize the true relationship. It is not disputed that if the true nature of the relationship is that of a shareholder-equity relationship after the retraction date and at the time of the reorganization, then the appellants do not have a claim provable in bankruptcy. Consequently, they will not have a claim under the *CCAA*.

As I see it, three main questions need to be addressed:

(1) Was Feldman J. correct in characterizing the relationship between Central Capital and the companies owned by James McCutcheon ("McCutcheon"), and between Central Capital and Scottish and York Holdings Limited (the predecessor to S.Y.H., hereinafter referred to as "SYH"), as a shareholder relationship?

(2) Did the nature of the relationship change after the retraction date for redeeming the shares of McCutcheon or, in the case of SYH, at the time of the reorganization?

(3) If the nature of the relationship is not a shareholder-equity relationship, are the appellants entitled to prove a claim under the *CCAA.?*

In addition, the appellants raise the question of whether they have a right to prove a claim for dividends, which have accrued but have not yet been declared payable. The price to be paid by Central Capital to McCutcheon on the retraction date, July 1, 1992, was $25 per share plus all accrued and unpaid dividends thereon. The dividends are therefore part of the retraction price. Similar provisions apply to SYH.

The reasons of Finlayson J.A. contain a comprehensive statement of the background to the litigation and I will therefore only refer to the facts in a summary fashion.

James McCutcheon and his brother sold their shares in Central Guarantee Trust Company to Central Capital Corporation ("Central Capital"), a trust company, for $575 a share. They received $400 per share in cash. The balance of $175 owing on each share was paid through the issue of seven preferred shares in Central Capital, with each share having a par value of $25. Following this transaction, McCutcheon purchased his brother's shares. These preferred shares, known as Senior Series B Preferred Shares,

were to be listed on the Toronto Stock Exchange. These shares carried with them a retraction privilege. The shareholder had the right to have his shares redeemed by Central Capital on July 1, 1992, for $25 a share, provided that such redemption would not be "contrary to law in the context of the Corporation's current financial position." McCutcheon chose not to sell his shares.

Scottish & York Holdings Limited (the predecessor to SYH) sold its shares in certain insurance companies which it owned to Central Capital. Central Capital paid for these shares by the issue of Series A Junior Preferred Shares. These shares were not listed on a stock exchange. SYH had the right to have its shares redeemed by Central Capital on or after September 1994 at a price of $1 per share, subject to the provisions of the *Canada Business Corporations Act,* R.S.C. 1985, c. C-44 (the "*CBCA*").

It should be noted that the right of retraction was not unique to these two classes of shareholders. Even common shareholders had the right to have their shares retracted under certain circumstances.

By December 1991, Central Capital was unable to pay its liabilities as they became due and its total liabilities greatly exceeded the value of its assets. As a result,

the various banks and subordinated debtholders, collectively referred to as the lenders, had a choice to make. Inasmuch as the definition of a corporation in s. 2 of the *Bankruptcy and Insolvency Act* precludes a creditor from bringing a petition against a trust company, they could either wind up Central Capital under the *Winding Up Act,* R.S.C. 1985, c. W-11, or they could try to restructure Central Capital under the *CCAA.* In a winding up or liquidation, the trustee would sell the company's assets, either piecemeal or as a going concern, to third parties. The proceeds from the sale would then be distributed to those who proved a claim according to set priority rules. In a reorganization, existing fixed amounts owed to Central Capital's creditors would be traded for new claims and ownership interests in the reorganized corporation which would remain a going concern. The lenders chose to reorganize.

Two transactions were involved. In the Consolidated Insurance Group Limited transaction, or "CIGL transaction", Central Capital transferred some of its significant assets to a newly incorporated company, CIGL. Thirty-nine creditors of Central Capital then elected to exchange a portion of Central Capital's debt owing to them for equity in this newly incorporated company. In the second transaction, common shares were issued for the remaining assets of Central Capital. The creditors of Central Capital were given 90 per cent of the common shares of the reorganized company. The

balance of 10 per cent was allocated to the shareholders of Central Capital. All of the preferred, common and subordinate voting shares in Central Capital were then converted into these "new" common shares. The reorganization was subsequently approved by the creditors and sanctioned by the Court as required by the Act, but this approval was given without prejudice to any claims that McCutcheon and SYH might have.

McCutcheon's position was that the right to have his shares retracted accrued before the reorganization, and that his exercise of this right of retraction in May 1992 constituted a present debt or liability entitling him to rank as a creditor in the CIGL transaction and in the reorganized Central Capital. SYH's position was that the right to have its shares retracted in 1994 created a future debt or liability and thus a provable claim. The administrator of Central Capital disallowed both claims. McCutcheon and SYH appealed the administrator's decision to Feldman J. In dismissing their appeals, she held that the appellants were shareholders and that the right of retraction attaching to the shares did not change the nature of the shares from equity into debt.

1. Was Feldman J. correct in characterizing the agreement between Central Capital and the companies owned by McCutcheon, and between Central Capital and SYH, as creating a shareholder relationship between the parties?

Feldman J. analyzed the transaction and came to the conclusion that it was an equity transaction.

Finlayson J.A. is of the opinion that the nature of this transaction is different and that Feldman J. erred in not showing sensitivity to the fact that she was dealing with the sale of a business by its owners. He is of the opinion that the shares issued by Central Capital are the equivalent to "vendor shares" in that the appellants received them in exchange for the transfer of assets to Central Capital. He does not see the transaction as being either a contribution to capital by McCutcheon and SYH or as a return of capital. Although the transaction has debt and equity features, Finlayson J.A. is of the opinion that the true nature of the transaction is that of a debt owing by Central Capital to McCutcheon and SYH for the shares in their companies.

My analysis of the transaction is that when McCutcheon sold his shares in Central Guaranty and took back preferred shares in Central Capital as part payment, he transferred part of his capital investment from a smaller entity to a larger entity. Similarly, SYH transferred its investment in the shares of the insurance companies for shares in the larger entity of Central Capital. Both appellants could look to a larger asset base than before to generate a return on their capital. Until the retraction date,

McCutcheon chose to take the risk of continuing his investment in Central Capital, which offered the prospect of a stable, yet relatively high, annual return through the receipt of 7-5/8 per cent dividends. Because the shares traded on the Toronto Stock Exchange, he would have had the option of realizing upon his investment by selling his shares for what they would bring on the open market, but he did not do so. In the case of SYH, although these shares were not required to be publicly listed, the corporation's articles did not restrict their transfer. The corporation's articles indicate that these shares had some preference over other shares with respect to the right to receive dividends and in the distribution of assets after creditors are paid on a liquidation. As preferred shareholders, McCutcheon and SYH did not have a voice in company affairs unless the company failed to pay the dividends it had promised to pay. This is quite typical: see Welling, *Corporate Law in Canada*, 2nd ed. (1991) at p. 604; Ziegel et al, *Cases and Materials on Partnership and Canadian Business Corporations*, 2nd ed. (1989) at p. 1198. Risk taking, profit sharing, transferability of investment, and the right to participate in a share of the assets on a liquidation after the creditors have been paid are the hallmarks of a shareholder: see R.M. Bryden "The Law of Dividends" contained in Ziegel ed., *Studies in Canadian Company Law* (1967) at p. 270. In my opinion, Feldman J. was correct that the true nature of the relationship between the parties initially was that of an equity transaction.

2. Did the nature of the relationship change after the retraction date for McCutcheon's shares and did the reorganization trigger a right of redemption respecting SYH's shares?

Ordinarily, shareholders cannot realize on their investment in a company except by transferring their shares. The retraction privilege attaching to the shares gives the preferred shareholders the option of realizing on their investment other than by transferring their shares to a third party.

Feldman J. found that McCutcheon continued to be a shareholder after the retraction date and that he remained a shareholder at the time of the reorganization. She found SYH's claim to be too remote inasmuch as the retraction date had not yet arrived at the time of the reorganization.

The appellants argue that Feldman J. erred in this conclusion. They submit that although McCutcheon and SYH may have been shareholders initially, this relationship changed. Upon McCutcheon's exercise of his right to have the corporation pay him the retraction price of his shares, he ceased to be a shareholder. When Central Capital failed to pay him, he became a creditor of the corporation. In the case of SYH, it is submitted that when the lenders opted to reorganize the company, they, in effect, triggered the obligation to redeem SYH's shares.

a) Nature of the transaction's relationship to the Capital Structure of the Corporation

Section 25(3) of the *CBCA* states that shares shall not be issued until the consideration for the shares is fully paid either in cash or with property having a fair market value equivalent to the shares issued. Therefore, by issuing preferred shares with a fixed par value, Central Capital paid McCutcheon for his shares of Central Guaranty and paid SYH for the shares of the insurance companies that Central Capital received. Central Capital could not issue preferred shares *except* as full payment for the shares it received. The preferred shares were part of the capital of Central Capital and the preferred shares were always shown as shareholders' equity on Central Capital's books. The capital of the corporation is representative of the assets available to pay creditors. If, on the date for redemption of McCutcheon's shares, or on the date of reorganization in the case of SYH, the shares are redeemed, the amount paid must be deducted from the stated capital of the corporation: s. 39 *CBCA*. Consequently, the total assets that Central Capital will have available to pay the lenders and other creditors outside the corporation will be reduced. A reduction of capital by the redemption of redeemable shares is permitted under the *CBCA* but only where the requirements of s. 36 are met.

b) Section 36 of the *CBCA*

Section 36 of the *CBCA* makes the ability of a corporation to redeem its redeemable shares subject to (1) its articles and (2) a solvency requirement. For ease of reference s. 36 is reproduced below.

> 36. (1) Notwithstanding subsection 34(2) or 35(3) [both of which deal with a corporation's acquisition of its own shares in other circumstances], but *subject to subsection (2) and to its articles*, a corporation may purchase or redeem any redeemable shares issued by it at prices not exceeding the redemption price thereof stated in the articles or calculated according to a formula stated in the articles.
>
> (2) A corporation shall not make any payment to purchase or redeem any redeemable shares issued by it if there are reasonable grounds for believing that
>
> (a) the corporation is, or would after the payment be, unable to pay its liabilities as they become due; or
>
> (b) the realizable value of the corporation's assets would after the payment be less than the aggregate of
>
> (i) its liabilities, and
>
> (ii) the amount that would be required to pay the holders of shares that have a right to be paid, on a redemption or in a liquidation, rateable with or prior to the holders of shares that have a right to be paid, on a redemption or in a liquidation, rateable with or prior to the holders of the shares to be purchased or redeemed.
>
> [Emphasis added.]

There is no dispute that Central Capital was unable to redeem McCutcheon's shares on the retraction date. Nor could it redeem SYH's shares on the date of the reorganization. The appellants agree that the effect of s. 36 renders the agreement between themselves and Central Capital unenforceable. It is the position of the appellants, however, that s. 36 does not extinguish a debt or liability which they say has been created. The appellants rely on the decision in *Re East Chilliwack Agricultural Co-operative* (1989), 74 C.B.R. (N.S.) 1 (B.C.C.A.) in support of their position that a debt or liability is created notwithstanding the solvency requirements of s. 36 respecting payment. The appellants' submission does not take into consideration the major differences between the decision in *East Chilliwack* and the present situation relating to the timing, effect of the solvency requirements and the provisions in the articles governing the relationship of the parties.

1) In *East Chilliwack,* farmers who owned shares in an agricultural co-operative gave notice to the co-op of their intention to have their shares redeemed. After the notices had been given, the superintendent of co-operatives suspended the right of the co-op to redeem its shares. Here, the request to redeem the shares by McCutcheon and the retraction date occurred after Central Capital had sent out a notice that it would not be able to redeem the shares due to its

financial position. SYH had no right to demand that its shares be retracted until the retraction date, which was some two years after the date of Central Capital's insolvency.

As in the instant case, the issue in *East Chilliwack* was whether the farmers were entitled to rank with the creditors of the co-op. Hutcheon J.A., with Toy J. A. concurring, held that they were entitled to be treated as creditors.

At the outset of his reasons, Hutcheon J.A. noted, at p. 11, that the effect of the superintendent's suspension on the farmers' rights was not argued on appeal and that the court had been asked to determine the status of the farmers without regard to the suspension.

Here, the effect of Central Capital's inability to redeem its shares due to insolvency is very much in issue and cannot be ignored. Although the articles provide for the redemption of all of the shares held by McCutcheon and SYH on or after the retraction date, the articles also state that Central Capital will only redeem so many of its shares as would not be "contrary to law." Pursuant to s. 36(1) of the *CBCA*, a corporation may purchase or redeem redeemable shares, but

the corporation is prohibited from doing so if the corporation is unable to pay its liabilities as they become due or if the assets of the corporation are less than the total of its liabilities and the amount required for the redemption. Because Central Capital could not comply with the solvency requirements, redemption would be "contrary to law."

2) In *East Chilliwack, supra,* at p. 13, the rules of the co-op provided that upon the giving of a notice of redemption, the farmer giving it ceased to be a shareholder. Central Capital's articles do not state that a request for redemption of the holder's shares terminates his status as a shareholder. McCutcheon continued to have the right to receive dividends pursuant to Article 4.5 while his shares were not redeemed. In effect, so long as Central Capital was unable to redeem the shares but had profits, McCutcheon continued to be entitled to a share of the profits through the declaration of dividends. If the dividends remained unpaid for eight consecutive quarters then, pursuant to Article 8, McCutcheon had the right to receive notice of, and to attend, each meeting of shareholders at which directors were to be elected and was entitled to vote for the election of two directors. The articles relating to the preferred shares held by SYH contain a

similar provision. The result of insolvency as envisaged by the articles was that McCutcheon and SYH would continue as shareholders.

3) In *East Chilliwack, supra,* Hutcheon J.A. held, at p. 13, that, subject to the power of the superintendent of co-operatives, the farmer's position would be that of an ordinary creditor.

Here, the terms attaching to McCutcheon's shares do not give him that right. Instead, he is given the right to continue to receive dividends so long as the company cannot pay him. The articles relating to the shares held by SYH contain a similar provision. In addition, Article 4.3(b), respecting the retraction of the shares, indicates that if the directors have acted in good faith in making a determination that the number of shares the corporation is permitted to redeem is zero, then the corporation is not liable in the event this determination proves inaccurate. This would hardly be the position *vis à vis* an ordinary creditor.

4) Article 8 and a similar provision in the articles relating to the shares held by SYH provide that upon a sale of all or a substantial part of the company's undertaking, the preferred shareholders have a right to receive notice of and to be

present at the meeting called to consider this sale. The farmers in *East Chilliwack* do not appear to have had any similar right.

5) Article 7 provides that in the event of a liquidation, dissolution or winding-up of the Corporation the preferred shareholders have a right to receive $25 per Series B Senior Preferred Share before the corporation pays any money or distributes assets to shareholders in any class subordinate or junior to the Series B Senior Preferred Shares. Similarly, SYH, as the holder of Series A and B Junior Preferred shares has the right, upon the dissolution or winding up of the corporation, to receive a sum equivalent to the redemption amount for each series junior preferred share. This right is subject to the rights of shares ranking in priority to the shares of these series, but is ahead of the rights of the holders of common shares.

Nothing in the articles concerning the retraction date affects the right of McCucheon and SYH to participate in Central Capital's liquidation. The participation of the farmer in *East Chilliwack* ceased once he had given notice to redeem. Article 4.4 of Central Capital provides that once the shares have been tendered for retraction this election is irrevocable on the part of the holder. In the

event that payment of the retraction price was not made, however, the holder had the right to have all deposited share certificates returned. Central Capital offered to return McCutcheon's shares to him, but he refused. Because McCutcheon retained all the rights and privileges of a preferred shareholder after the retraction date, the fact that he refused to take back his share certificates cannot alter the true nature of the relationship. The refusal was merely evidence of a dispute concerning what the relationship was. SYH also retained its full status as a shareholder until the date of the reorganization. This was not the situation in *East Chilliwack.*

By way of summary, on the date of the reorganization McCutcheon and SYH had not ceased to be preferred shareholders of Central Capital. The rights attaching to their retractable preferred shares entitled them to continue to share in the profits of the company when these were declared as dividends, to vote at shareholders meetings to elect directors so long as dividends remained unpaid for a specified period of time, and, on a winding up of the company, to participate in the distribution of assets that remained after the creditors were paid according to the ranking of the series of their shares. The company's obligation to redeem its shares was not absolute. Instead, the articles provided for what was realistically a "best efforts" buy-back based on solvency and

continuation as a shareholder to the extent a buy-back could not take place. In *East Chilliwack,* because the farmer ceased to be a shareholder, the articles do not appear to make any provision for continued participation or for the postponement of payment depending on the solvency of the co-op.

c) Evidence of a debtor-creditor relationship is lacking in the articles.

Looked at another way, after the retraction date and at the time of the reorganization, the common features of a debtor-creditor relationship are not in evidence in Central Capital's articles. The agreements between the parties contain no express provision that the redemption of the shares is in repayment of a loan. The corporation was not obliged to create any fund or debt instrument to ensure that it could redeem the shares on the retraction date. There is no indemnity in the event that the money is not repaid on the retraction date. There is no provision for the payment of any interest after the retraction date in the event that the money is not repaid on the retraction date. There is no provision that after the retraction date and in the event of insolvency, the appellants would have the right to have the company wound up. (See *R. v. Imperial General Properties Ltd.,* [1985] 2 S.C.R. 288 for a case where the articles of the company contained this right.) There is no provision that upon a winding up or insolvency the

parties are entitled to rank *pari passu* with the creditors as was the case in *Canada Deposit Insurance Corp. v. Canadian Commercial Bank, supra.*

d) The effect of the reorganization

Finlayson J.A. is of the view that it is immaterial that the articles provide, in the event of the liquidation, dissolution or winding-up of the company, that the appellants are only entitled to rank after the creditors but ahead of the junior ranking shareholders. In his view, this provision is irrelevant because we are not dealing with a liquidation but with a reorganization. He finds it significant that, like debtors, the preferred shareholders are not entitled to participate in any surplus once they have been paid. I am of the view that this provision in the articles is significant. It represents a clear indication that the holders of the retractable shares were not to be dealt with on the same footing as ordinary creditors even after the retraction date. Instead, they were to be dealt with as shareholders, albeit an elevated class. Under the *CBCA* all shares carry equal rights. Words used in the articles to differentiate a class of shares are nothing more than authorized deviations from this statutory position of equality: Welling, *supra,* at p.683.

The appellants submit that a winding-up or liquidation is not the same as a reorganization. This is true. Both, however, are methods of dealing with insolvency. Both are methods for secured creditors to enforce their claims by seizing the assets in which they hold security interests. If the value of the corporation as a going concern exceeds the liquidation value of the assets, it is in the interest of all the debt holders that the corporation be preserved as a going concern. The purpose of both a liquidation and a reorganization is to permit the rehabilitation of the insolvent person unfettered by debt: *Vachon v. Canada Employment and Immigration Commission,* [1985] 2 S.C.R. 417. By virtue of s. 20 of the *CCAA*, arrangements under the Act mesh with the reorganization provisions of the *CBCA* so as to affect the company's relations with its shareholders. Shareholders have no right to dissent to a reorganization: s. 191(7), *CBCA*. On a reorganization, among other things, the articles may be amended to alter or remove rights and privileges attaching to a class of shares and to create new classes of shares: s. 173, *CBCA*. These statutory provisions provide a clear indication that, on a reorganization, the interests of all shareholders, including shareholders with a right of redemption, are subordinated to the interests of the creditors. Where the debts exceed the assets of the company, a sound commercial result militates in favour of resolving this problem in a manner that allows creditors to obtain repayment of their debt in the manner which is most advantageous to them.

The similarities between a liquidation and a reorganization, together with the express statement in the articles of Central Capital with respect to what is to happen on a winding-up, dictate that the interests of the holders of retractable shares, McCutcheon and SYH, are subordinated to the creditors and they are not entitled to claim under the *CCAA* equally with the creditors. This position is also consistent with the provisions of the *Bankruptcy and Insolvency Act* and the *Winding-Up Act*. In the case of an insolvency where the debts to creditors clearly exceed the assets of the company, the policy of federal insolvency legislation appears to be clear that shareholders do not have the right to look to the assets of the corporation until the creditors have been paid.

Dividends

Although dividends were payable on the shares of McCutchon and SYH, no dividends were in fact declared. The appellants contend that the dividends, which have accrued but which were not declared, are a debt or liability because they were stipulated to be part of the retraction price.

Article 7 of Central Capital respecting McCutcheon's shares states that in the event of a liquidation, dissolution or winding up of the corporation, the shareholders

are entitled to receive not only the $25 per Series B preferred share, but "all accrued and unpaid dividends thereon, whether or not declared ... before any amount is paid by the Corporation or any assets of the Corporation are distributed to the holders of any shares...ranking as to capital junior to the Series B Senior preferred Shares."

It is trite law that a dividend may only be declared if a company is solvent. For corporations governed by the *CBCA,* it appears that the common law tests for solvency have all been subsumed or overruled: *R. v. McClurg,* [1991] 2 W.W.R. 244 at 259, 260 (S.C.C.).

> Section 42 of the *CBCA* provides:
>
> A corporation shall not declare or pay a dividend if there are reasonable grounds for believing that
>
> (a) the corporation is, or would after the payment be, unable to pay its liabilities as they become due; or
>
> (b) the realizable value of the corporation's assets would thereby be less than the aggregate of its liabilities and stated capital of all classes.

Section 42 prevents the corporation from declaring or paying a dividend when it does not meet certain solvency requirements. There was no declaration of a

dividend in the present case. Any obligation to pay a dividend as part of the retraction price cannot therefore be enforced when the company is insolvent. Dividends which have accrued but which are unpaid are not considered to be a debt because, on reading the articles as a whole, the provision for payment is not one which is made independant of the ability to pay: see *Welling, supra,* at p. 689, citing *International Power Co. Ltd. v. McMaster University and Montreal Trust Co.,* [1946] S.C.R. 178 where it was held there was no guarantee of payment and hence the accrued but unpaid dividends were not a debt. Instead, accrued but unpaid dividends are considered to be akin to a return of capital. Making these accrued dividends part of the retraction price does not alter this.

By way of analogy to the treatment of dividends, it could be said that until the company has declared it will redeem the shares which are tendered to it the obligation to redeem them is not a debt or liability. The promise to pay in the articles of Central Capital is not made independent of any ability to pay.

In the event that I am wrong in my conclusion that the true nature of the relationship is one of equity, I shall now consider the position in the event that a debt has been created.

3. If the nature of the relationship is not an equity relationship are the appellants entitled to be claimants under the *CCAA*.?

The parties agree that the effect of s. 36 renders the agreement to redeem their preferred shares unenforceable. It is the position of the appellants, however, that s. 36 does not extinguish Central Capital's obligation to repay them. Their position is that Central Capital's obligation to repay them is a contingent liability and therefore gives them a claim provable in bankruptcy, bringing them under s. 12(1) of the *CCAA*.

The Meaning of Debt

Debt is defined in a very broad manner in *Black's Law Dictionary*, 6th ed. (1990) at p. 403. It is the position of the appellants that this definition of "debt" is broad enough to include McCutcheon's right to have Central Capital redeem his shares. In the case of SYH, it is submitted that the right to redemption constitutes a future liability. It is the appellants' position that Feldman J. erred in holding that to have a provable claim, McCutcheon and Central Capital must be able to obtain a judgment against Central Capital for the retraction price and be entitled to seek payment on the judgment. Finlayson J.A. agrees with the appellant's position.

Debt is defined in *Black's Law Dictionary*, *supra*, as:

> A sum of money due by certain and express agreement. A specified sum of money owing to one person from another, including not only obligation of debtor to pay but right of creditor to receive and enforce payment.
>
> A fixed and certain obligation to pay money or some other valuable thing or things, either in the present or in the future. In a still more general sense, that which is due from one person to another, whether money, goods, or services. In a broad sense, any duty to respond to another in money, labour, or service; it may be even a moral or honorary obligation, unenforceable by legal action. Also, sometimes an aggregate of separate debts, or the total sum of the existing claims against person or company. Thus we speak of the "national debt", the "bonded debt" of a corporation, etc.

It will be readily apparent that in *Black's* the term "debt" is defined in two distinct ways. In order to constitute a debt as defined in the first paragraph, the obligation must be enforceable. In the second paragraph debt is defined more broadly as any duty or obligation even if unenforceable by legal action. Feldman J. considered the first portion of the definition in her reasons. If the first portion of the definition applies, no debt is created because the obligation is not enforeceable under the *CBCA*. The appellants rely on the second portion of the definition. They also rely on the definition of of the word "liability" in *Black's* which is also defined very broadly.

In one sense, support for the position of the appellants is found in s. 40 of the *CBCA*. Section 40 states that a contract with a corporation providing for the purchase of shares of the corporation is specifically enforceable against the corporation except to the extent that the corporation cannot perform the contract without being in breach of ss. 34 or 35. Section 34 contains the solvency requirements concerning the redemption by a company of its own shares other than those carrying a right of redemption. Section 35 deals with shares which have been issued to settle or compromise a debt. In s. 2, "liability" is defined as including "a **debt** of a corporation arising under section 40 ...."

Section 40 does not include any reference to the obligation of a company to repurchase redeemable shares under s. 36. As a result s. 36 is not incorporated by reference into the definition of liability. While it might be suggested that this is a legislative oversight, the omission is also consistent with the position that only the articles of the corporation govern the relationships between the company and the holders of the retractable shares under s. 36. I have already stated my opinion that the articles of Central Capital do not make the obligation to redeem the shares a debt or, for that matter, a liability. Moreover, even if a provision like s. 40 is implied with respect to redeemable preferred shares, it would also be necessary to imply a provision like s. 40(3)

which states that in the event of liquidation where the company has not performed its contract to redeem, the other party is entitled to be ranked subordinate to the rights of creditors but in priority to the shareholders. This is a clear expression of legislative intention that on insolvency the claim of those entitled to have their shares redeemed should not be placed on the same footing with the claims of creditors but should rank subordinate to them: see *Nelson v. Rentown Enterprises Inc.*, [1994] 4 W.W.R. 579 (Alta. C.A.), adopting the reasons of Hunt J. at 96 D.L.R. (4th) 586 (Alta. Q.B.). Policy reasons would again militate in favour of the result being the same on a reorganization.

Claims in Bankruptcy

Even if the broader definitions of a debt or liability in *Black's* are adopted, the appellants still do not have a claim provable in bankruptcy.

Persuasive authority already exists to the effect that in order to be a provable claim within the meaning of s. 121 of the *Bankruptcy and Insolvency Act* the claim must be one recoverable by legal process: *Farm Credit Corporation v. Holowach (Trustee of)*, [1988] 5 W.W.R. 87 at 90 (Alta. C.A.), leave to appeal to the Supreme Court of Canada dismissed at [1989] 4 W.W.R. lxx.

In *Holowach*, the seven members of the court were dealing with a situation in which some persons borrowed money from a mortgagee and mortgaged certain lands as security for repayment of the loan. The mortgagors then made an assignment in bankruptcy. The mortgagee filed a proof of claim for the full amount of the deficiency, that is, the amount of the indebtedness less the value of the land which the mortgagee was permitted to purchase. The Alberta *Law of Property Act*, R.S.A. 1980, c.L-8 precluded deficiency claims against individuals in foreclosure actions, although the effect of the legislation was not to extinguish or satisfy the debt. The mortgagee argued that it had a claim provable in bankruptcy under s. 95(1), now s. 121(1), of the *Bankruptcy and Insolvency Act*. The court rejected this argument, holding that a provable claim must be one recoverable by legal process. In coming to its conclusion, the court relied on *Ref. re Debt Adjustment Act, 1937,* [1943] 1 All E.R. 240, (P.C.) and a number of decisions at the trial level which are collected at p. 91 of the decision.

Here, the contract to repurchase the shares, while perfectly valid, is without effect to the extent that there is a conflict between the corporation's promise to redeem the shares and its statutory obligation under s. 36 of the *CBCA* not to reduce its capital where it is insolvent. As was the case in the *Holowach* decision, this statutory overlay renders Central Capital's promise to redeem the appellants' preferred shares

unenforceable. Although there is a right to receive payment, the effect of the solvency provision of the *CBCA* means that there is no right to enforce payment. Inasmuch as there is no right to enforce payment, the promise is not one which can be proved as a claim.

It could be suggested that the decision in *Holowach* can be distinguished from the instant case on the basis that in *Holowach* the claim is made unenforceable forever by statute whereas under the *CCAA* the claim is unenforceable only so long as the corporation does not meet the solvency requirements of s. 36 of the *CBCA*. I do not believe this is a valid distinction for three reasons. First, the relevant date for determining any contingent liability is not the future but the past, namely, September 8, 1992, the date by which proofs of claim had to be submitted. On that date, Central Capital was insolvent. Second, it is only because the lenders were willing to convert their debt obligations into equity in the reorganization that Central Capital is now solvent. Central Capital is not the same company and its liabilities are not the same. The redeemable shares no longer exist. Third, in order to be profitable, the assets of a company must be managed. Any value in the assets after the insolvency of the company is, in this case, due to the new management and not to the preferred shareholders extending credit to the company by having their claim for redemption postponed.

Even if Central Capital's obligation to redeem the shares of the appellants created a debt or liability, the appellants do not have a claim provable within the meaning of s. 121 of the *Bankruptcy and Insolvency Act*.

CONCLUSION

I would dismiss the appeal. For the reasons I have given, the retraction amounts do not constitute a debt or liability within the meaning of s. 121 of the *Bankruptcy and Insolvency Act*. Even if I am wrong in my conclusion and a debt or liability is created, it is not a claim within the meaning of the *CCAA*. This is a case of first impression. For these reasons, I would not award any costs of this appeal.

Royal Bank of Canada v. Central Capital Corp., 1996 CanLII 1521 (ON C.A.)

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C21479 C21477

COURT OF APPEAL FOR ONTARIO

FINLAYSON, WEILER and LASKIN JJ.A.

**IN THE MATTER OF Central Capital Corporation;
AND IN THE MATTER OF THE Companies' Creditors Arrangement Act, R.S.C. 1985, c. 36, as amended**

AND IN THE MATTER OF AN APPEAL FROM THE DISALLOWANCE OF THE CLAIMS OF JAMES W. McCUTCHEON, CENTRAL GUARANTEE TRUST COMPANY, AS TRUSTEE FOR THE REGISTERED RETIREMENT SAVINGS PLAN OF JAMES W. McCUTCHEON AND CONSOLIDATED S.Y.H. CORPORATION BY PEAT MARWICK THORNE INC. ADMINISTRATOR OF CERTAIN ASSETS OF CENTRAL CAPITAL CORPORATION

B E T W E E N:	)
ROYAL BANK OF CANADA, BANCA COMMERCIALE ITALIANA OF CANADA, CREDIT LYONNAIS CANADA, DAI-ICHI KANGYO BANK (CANADA), PRUDENTIAL ASSURANCE COMPANY LIMITED, PRUDENTIAL GLOBAL FUNDING, INC., SANWA THE BANK OF TOKYO CANADA, THE TORONTO-DOMINION BANK, WESTDEUTSCHE LANDESBANK GIROZENTRALE, BACOB SAVINGS BANK s.c., BANCA NAZIONALE DEL LAVORO OF CANADA, BANCO DI ROMA (LONDON), COMMERZBANK INTERNATIONAL S.A., CREDIT COMMERCIAL DE FRANCE, CREDIT COMMUNAL DE BELGIQUE S.A., CREDIT SUISSE (LUXEMBOURG) S.A., DG BANK LUXEMBOURG S.A.) KREDIETBANK NV (BELGIUM), NIPPON TRUST BANK LIMITED, OLFRN INVESTMENT (PANAMA) INC., PAUL REVERE LIFE INSURANCE, RBC Trust	**Bryan Finlay, Q.C. and John M. Buhlman for James W. McCutcheon and Central Guaranty BANK CANADA,** **James H. Grout and Anne Sonnen for Consolidated S.Y.H. Corporation** **Terence J. O'Sullivan and Paul G. Macdonald for the**

TAB 3

In the Matter of Stirling Homex Corporation, Debtor.gregory Jezarian, Geraldine Jezarian, Lonetown Company,harry E. Jones, Aleck Goldberg, As Custodian Formark Goldberg, and Mrs. D. Windsordixon, Appellants, v. Frank G. Raichle, Reorganization Trustee, Lincoln First Bankof Rochester, Chemical Bank, the Chase Manhattan Bank, N.a., the First National Bank of Chicago, Marine Midland Bank,the Travelers Indemnity Company, and the Securities Andexchange Commission, Appellees

United States Court of Appeals, Second Circuit. - 579 F.2d 206

Argued March 20, 1978.Decided June 19, 1978

Robert B. Block, New York City (Pomerantz, Levy, Haudek & Block, New York City, of counsel), for appellants Gregory Jezarian, Geraldine Jezarian and Lonetown Company.

I. Walton Bader, New York City (Bader & Bader, New York City, of counsel), for appellant Mrs. D. Windsor Dixon.

Milberg, Weiss, Bershad & Spechtrie, New York City, of counsel, for appellants Harry E. Jones and Aleck Goldberg, as Custodian for Mark Goldberg.

Irving H. Picard, Asst. Gen. Counsel, S. E. C., Washington, D. C. (David Ferber, Sol. to the Commission, S. E. C., Washington, D. C., Marvin E. Jacob, Associate Administrator, S. E. C., New York Regional Office, New York City, of counsel), for appellee Securities and Exchange Commission.

Frank G. Raichle, Buffalo, N. Y. (Byron Johnson, Johnson, Reif & Mulligan, P. C., Rochester, N. Y., of counsel), for trustee-appellee Frank G. Raichle.

Henry L. Goodman, New York City (Zalkin, Rodin & Goodman, Richard S. Toder, Andrew D. Gottfried, New York City, Sherman I. Goldberg, Chicago, Ill., of counsel), for appellees, Chemical Bank and The First National Bank of Chicago.

Alexander C. Cordes, Buffalo, N. Y. (Phillips, Lytle, Hitchcock, Blaine & Huber, Buffalo, N. Y., of counsel), for appellee Marine Midland Bank.

Nixon, Hargrave, Devans & Doyle, Rochester, N. Y., of counsel, for appellee Lincoln First Bank of Rochester.

Milbank, Tweed, Hadley & McCloy, John J. Jerome, Barry G. Radick, Michael J. Levin, Patrick E. Mears, New York City, of counsel, for appellee The Chase Manhattan Bank, N. A.

Brown, Kelly, Turner, Hassett & Leach, Buffalo, N. Y. (Frederick D. Turner, Buffalo, N. Y., of counsel), for appellee The Travelers Indemnity Company.

Before KAUFMAN, Chief Judge, and MULLIGAN and MESKILL, Circuit Judges.

MESKILL, Circuit Judge:

1 This appeal raises questions concerning the proper status of allegedly defrauded investors in reorganization proceedings under Chapter X of the Bankruptcy Act. The principal issue is whether claims filed by allegedly defrauded stockholders of a debtor corporation should be subordinated to claims filed by that corporation's ordinary unsecured creditors for purposes of formulating a reorganization plan. Judge Harold P. Burke of the United States District Court for the Western District of New York held that they should be, and we affirm.

2 The debtor in this case is Stirling Homex Corporation ("Homex").[1] As recently explained by this Court, "Homex manufactured and assembled prefabricated multi-family modular housing. Its operations consisted of mass-producing individual apartment units, or 'modules,' using assembly-line production techniques, shipping them to a construction site and installing them in a previously-constructed concrete and steel frame so as to form multi-unit apartment buildings." United States v. Stirling, 571 F.2d 708, 712 (2d Cir. 1978), Petition for cert. filed, 46 U.S.L.W. 3723 (U.S. May 1, 1978). The nature of Homex's actual operations, however, did not reflect the basically sound and straightforward character of the corporation's underlying concept. Instead, its operations included "land transactions that were not what they were claimed to be, labor relations that were not only inappropriately 'cozy' but undisclosed, contracts for module sales based on guile and trickery rather than agreement, and deceptive bookkeeping practices . . . ." 571 F.2d at 713. Key officials of the corporation "engaged collectively in a calculated and multi-faceted plan to give the investing public the false impression that Homex was in a sound and steadily improving financial position and at the same time withhold adverse information that was material to an accurate appraisal of the company's prospects." 571 F.2d at 713-14.[2]

3 On July 12, 1972, after Homex had been in business for approximately four years, reorganization proceedings were voluntarily initiated in the Western District of New York under Chapter X of the Bankruptcy Act, 11 U.S.C. § 501 Et seq.[3] Nearly five years later, in July of 1977, Judge Burke determined that the fair market value of Homex's assets was $16,986,376 and that Homex's debts amounted to $45,961,000.[4] Accordingly, he found Homex insolvent and declared that Homex stockholders had no equity in the corporation and could neither vote on a plan of reorganization nor

share in the distribution of proceeds resulting from the liquidation of Homex's assets. Judge Burke then ordered the Trustee to prepare and submit a plan for such a distribution.

4 That same month, at the request of the Trustee and with the consent of the stockholders, Judge Burke filed a written decision in which he held that the claims of allegedly defrauded stockholders, some of whom had begun proceedings against Homex and its officers for violations of federal securities laws,[5] were subordinate to those of Homex's general unsecured creditors. Relying on § 197 of the Bankruptcy Act, 11 U.S.C. § 597, and Bankruptcy Rule 10-302(a), Judge Burke ordered that claims by "those creditors whose claims are grounded on fraud or securities law violations committed upon them as stockholders" be subordinated. In so doing, he made the following observations:

5 If the claims of alleged defrauded stockholders are not subordinated to the claims of conventional general unsecured creditors, a wholly new element will have been created in the financial structure of business. No longer will creditors, whether banks, suppliers, or subcontractors, be free as they now are to extend credit to the ordinary course of business on their presumed right to be accorded priority over the claims of investors and speculators in securities, without first obtaining a secured basis which will guarantee them a priority status in the event their customer defaults. Such a fundamental change in the financial structure of the business community is unwarranted in the absence of legislation designed to overturn the long established rule of absolute priority.

6 . . . I find that (it) is fair and equitable that the class of conventional general creditors take precedence over the class of alleged defrauded stockholder claims.

7 Defrauded stockholder claimants in the purchase of stock are presumed to have been bargaining for equity type profits and assumed equity type risks. Conventional creditors are presumed to have dealt with the corporation with the reasonable expectation that they would have a senior position against its assets, to that of alleged stockholder claims based on fraud. They may be presumed to have bargained for debt type profits and certainty of payments.

8 For the reasons that follow, we affirm Judge Burke's order.[6]

9 DISCUSSION

10 One of the more significant responsibilities assigned to the bankruptcy court in a Chapter X proceeding is to supervise the formulation of a plan of reorganization that is not only "feasible" but also "fair and equitable." See 11 U.S.C. §§ 574, 621(2). Central to the accomplishment of this task is the proper classification and ordering of the debtor corporation's creditors and stockholders: "For the purposes of the plan and its acceptance, the judge shall fix the division of creditors and stockholders into classes according to the nature of their respective claims and stock." 11 U.S.C. § 597; See Bankruptcy Rule 10-302(a).[7]

11 As explained by the Tenth Circuit in 1945, this classification of claims "is simply a method of recognizing difference in rights of creditors which calls for difference in treatment." Scherk v. Newton, 152 F.2d 747, 750. Once classified, the various classes must not only be ranked "according to the nature of their respective claims," but also according to the "absolute priority" rule. Under this rule,

no class may receive anything of value until senior classes have received full compensation for the value of their claims. For example, creditors holding security interests in the assets of the debtor must be ranked ahead of all other creditors with respect to those assets. After the satisfaction of the secured creditors, general unsecured creditors are entitled to satisfaction before assets may be allocated to creditors whose interests have been subordinated, whether by express agreement or otherwise. Finally, after all creditors have been paid, provision may be made for stockholders. When the debtor is insolvent, the stockholders, as such, receive nothing. See Northern Pacific Ry. v. Boyd, 228 U.S. 482, 33 S.Ct. 554, 57 L.Ed. 931 (1913); Case v. Los Angeles Lumber Co., 308 U.S. 106, 60 S.Ct. 1, 84 L.Ed. 110 (1939); Consolidated Rock Co. v. DuBois, 312 U.S. 510, 61 S.Ct. 675, 85 L.Ed. 982 (1941); Protective Committee v. Anderson, 390 U.S. 414, 88 S.Ct. 1157, 20 L.Ed.2d 1 (1968). See also Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 435-38, 92 S.Ct. 1678, 32 L.Ed.2d 195 (1972) (Douglas, J., dissenting); See generally 6A Collier on Bankruptcy P 11.06. The question on this appeal, of course, is not whether Homex stockholders are entitled, as stockholders, to a portion of the proceeds that will result from the liquidation of Homex's assets. Because of the absolute priority rule, they are not. Rather, the question is whether persons who were allegedly induced by fraud to purchase Homex stock should be allowed, in a reorganization proceeding, to assert claims in such a way as to achieve parity with ordinary unsecured tort and contract claimants.[8]

12 Section 106(4) of the Bankruptcy Act, 11 U.S.C. § 506(4), defines "creditor" as "the holder of any claim." Section 106(1) of the Act,11 U.S.C. § 506(1), defines "claims" to "include all claims of whatever character against a debtor or its property, except stock, whether or not such claims are provable under section 103 of this title and whether secured or unsecured, liquidated or unliquidated, fixed or contingent." As noted in Collier :

13 The word "claims" as defined in § 106(1) is sweeping in scope. Within its purview is any character of a claim against the debtor or its property, whether or not such claim is provable under § 63 of the Act, and whether secured or unsecured, liquidated or unliquidated, fixed or contingent. This is, of course, a more inclusive definition than that applicable in ordinary bankruptcy, and it should be given a broad construction with respect to claims and creditors in order to dispose of all liabilities of the debtor in reorganization.

14 6 Collier on Bankruptcy P 2.05, at 306 (footnotes omitted). Thus, inasmuch as the stockholders on this appeal are basing their claims not on their ownership of stock certificates but on the alleged fraud that was perpetrated upon them by the corporation when they purchased those certificates, they are, at least arguably, "creditors" making "claims" for purposes of a Chapter X reorganization. With this Judge Burke seems to have agreed, for he referred to both "conventional general creditors" and "those creditors whose claims are grounded on fraud or securities law violations committed upon them as stockholders." See also In Re Four Seasons Nursing Centers of America, Inc., 472 F.2d 747, 749-50 (10th Cir. 1973). On this appeal we will assume, as Judge Burke did, without deciding, that defrauded stockholders are creditors within the meaning of the Bankruptcy Act, and we will consider the more narrow question whether it was inequitable for Judge Burke to subordinate the claims by the stockholders to those made by ordinary general creditors. We conclude that it was not.

15 In Pepper v. Litton, 308 U.S. 295, 60 S.Ct. 238, 84 L.Ed. 281 (1939), the Supreme Court agreed to review a lower court decision "because of an apparent restriction imposed by that decision on the

power of the bankruptcy court to disallow or to subordinate . . . claims in the exercise of its broad equitable powers." 308 U.S. at 296, 60 S.Ct. at 240. In the course of its opinion, the Court reaffirmed that " 'courts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity.' " 308 U.S. at 304, 60 S.Ct. at 244, Quoting Local Loan Co. v. Hunt, 292 U.S. 234, 240, 54 S.Ct. 695, 78 L.Ed. 1230 (1934). Accordingly, the bankruptcy court is to apply "the principles and rules of equity jurisprudence." 308 U.S. at 304, 60 S.Ct. at 244. See also 11 U.S.C. § 11(a). The Court also said that among the powers available to the bankruptcy court to effect this mandate is the power of "subordination in light of equitable considerations." 308 U.S. at 305, 60 S.Ct. at 244.

16 The mere fact that an officer, director, or stockholder has a claim against his bankrupt corporation or that he has reduced that claim to judgment does not mean that the bankruptcy court must accord it Pari passu treatment with the claims of other creditors. Its disallowance or subordination may be necessitated by certain cardinal principles of equity jurisprudence.

17 308 U.S. at 306, 60 S.Ct. at 245. The Court also noted:

18 In the exercise of its equitable jurisdiction the bankruptcy court has the power to sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate. And its duty so to do is especially clear when the claim seeking allowance accrues to the benefit of an officer, director, or stockholder. That is clearly the power and duty of the bankruptcy courts under the reorganization sections.

19 308 U.S. at 307-08, 60 S.Ct. at 246 (footnote omitted). See also In Re Four Seasons Nursing Centers of America, Inc., supra, 472 F.2d at 749 ("The reorganization court as a court of equity has broad powers in the matter of classifying creditors and shareholders, and it necessarily has full power to subordinate interests or classes of interests where the equities demand."); In Re Sixty-Seven Wall Street Restaurant Corp., 23 F.Supp. 672, 673, 674 (S.D.N.Y.1938).

20 Collier has made similar observations regarding subordination which are directly relevant to this appeal:

21 Creditors holding claims against the debtor's estate of a kind not secured within the meaning of the Act are classified as unsecured or general creditors. The fact that the claims may take various forms as, for example, notes, accounts, written contracts, torts or the like will not ordinarily compel separate classification since an unsecured indebtedness or liability is the common denominator of all.

22 Within the total group of unsecured creditors, however, there may be certain ones whose claims are of such a nature as to give them some right of priority or preference over other claimants. These creditors, then, must be separately classified and accorded the priority to which they are entitled.

23 6 Collier on Bankruptcy P 9.13, at 1620-21 (footnotes omitted).

24 Subordination is a means of regulating distribution results in reorganization by adjusting the respective order of claimants and stockholders to the equitable levels of the comparative claim positions in the proceeding. Its fundamental aim to is undo or offset any inequity in the position of a

creditor or stockholder which will produce injustice or unfairness to the other creditors or stockholders in terms of reorganization results.

25 6 Collier on Bankruptcy P 9.15, at 1644-45. Given the broad equitable powers with which the bankruptcy court is endowed, and given the expectations that conventional creditors and investors have when they extend credit or invest, we cannot say that Judge Burke acted improperly.

26 Where the debtor corporation is insolvent and is about to undergo complete liquidation, the equities favor the conventional general creditors rather than the allegedly defrauded stockholders. In such circumstances, "(t)he real party against which (the stockholders) are seeking relief is the body of general creditors of their corporation. Whatever relief may be granted to them in this case will reduce the percentage which the general creditors will ultimately realize upon their claims." Scott v. Abbott, 160 F. 573, 581 (8th Cir.), Cert. denied, 212 U.S. 571, 29 S.Ct. 682, 53 L.Ed. 655 (1908). We will not allow stockholders whose claims are based solely on the alleged fraud that took place in the issuance of stock to deplete further the already meager pool of assets presently available to the general creditors. See also Matter of Cartridge Television, Inc., 535 F.2d 1388 (2d Cir. 1976) (straight bankruptcy); In the Matter of Crimmins, 406 F.Supp. 282 (S.D.N.Y.1975) (straight bankruptcy). In so deciding, we heed the observation made many years ago by the Eighth Circuit: "When a corporation becomes bankrupt, the temptation to lay aside the garb of a stockholder, on one pretense or another, and to assume the role of a creditor, is very strong, and all attempts of that kind should be viewed with suspicion." Newton National Bank v. Newbegin, 74 F. 135, 140 (8th Cir. 1896). We also note that, "(a)s a general rule equity prefers the claims of innocent general creditors over the claims of shareholders or subordinated creditors deceived by officers of the corporation." F.D.I.C. v. American Bank Trust Shares, Inc., 412 F.Supp. 302, 308 (D.S.C.1976), Vacated on other grounds, 558 F.2d 711 (4th Cir. 1977). See also Scott v. DeWeese, 181 U.S. 202, 213, 21 S.Ct. 585, 45 L.Ed. 822 (1901); Sanger v. Upton, 91 U.S. (1 Otto) 56, 60, 23 L.Ed. 220 (1875); Upton v. Tribilcock, 91 U.S. (1 Otto) 45, 47, 23 L.Ed. 203 (1875); Carter v. Bogden, 13 F.2d 90, 93-94 (8th Cir. 1926); Scott v. Abbott, supra, 160 F. at 582.

27 This general rule is altogether fitting. When persons or institutions lend money to a corporation, or otherwise become its creditors, they do so in reliance upon the protection and security provided by the money invested by the corporation's stockholders the so-called "equity cushion." In effect, when stock is purchased, the purchaser of that stock invites other segments of the business world to do business with the issuer. "This (reliance) is not only theoretically true, but common experience teaches that it is practically true also." Scott v. Abbott, supra, 160 F. at 582. The general creditors also rely on the absolute priority rule when deciding to extend credit: "The reliance need not be manifest the stockholders are presumed to have knowledge of priority rights. . . . Credit is given to corporations with little or no knowledge of names of stockholders, but with confidence that, whoever they are, their rights in and to corporate property are subordinate to the rights of creditors." Huff, The Defrauded Investor in Chapter X Reorganizations: Absolute Priority v. Rule 10b-5, 50 Am.Bankr.L.J. 197, 205 (1976).

28 As explained in a leading article on this question, Slain & Kripke, The Interface Between Securities Regulation and Bankruptcy Allocating the Risk of Illegal Securities Issuance Between Security Holders and the Issuer's Creditors, 48 N.Y.U.L.Rev. 261 (1973), there are two entirely distinct types of risks taken by creditors and investors when they decide to do business with a corporation: the risk

of insolvency of the debtor and the risk of unlawful issuance of securities. Id. at 286. It is appropriate that both the general creditors and the investors assume the risk of insolvency. As between the creditors and the investors, however, only the investors should be forced to bear the risk of illegality in the issuance of stock.

29 In theory, the general creditor asserts a fixed dollar claim and leaves the variable profit to the stockholder; the stockholder takes the profit and provides a cushion of security for payment of the lender's fixed dollar claim. The absolute priority rule reflects the different degree to which each party assumes a risk of enterprise insolvency; no obvious reason exists for reallocating that risk.

30 Id. at 286-87. Slain and Kripke also note that "(i)t is difficult to conceive of any reason for shifting even a small portion of the risk of illegality (in the stock issuance) from the stockholder, since it is to the stockholder, and not the creditor, that the stock is offered." Id. at 288. With this we quite agree.

31 Finally, we note that the United States Congress is in the process of considering this very question as part of its review of the entire law of bankruptcy. Section 510 of H.R. 8200, 95th Cong., 1st Sess. (1978), which was passed by the House of Representatives on February 1, 1978, 124 Cong.Rec. at H. 457 (1978), provides as follows:

32 Subordination of Claims

33 (a) After notice and a hearing, the court shall

34 (2) subordinate for purposes of distribution any claim for rescission of a purchase or sale of a security of the debtor or of an affiliate or for damages arising from the purchase or sale of such a security to all claims and interests that are senior or equal to the claim or interest represented by such security.

35 (b) Notwithstanding subsection (a) of this section, after notice and hearing, the court may, on equitable grounds

36 (1) subordinate for purposes of distribution all or part of an allowed claim or interest to all or any part of another allowed claim or interest. . . .

37 Section 510 of the parallel Senate bill, S. 2266, contains virtually identical language. S. 2266, 95th Cong., 1st Sess. (1977). The report on H.R. 8200 of the House Committee on the Judiciary, H.R.Rep.No.95-595, 95th Cong., 1st Sess. (1977), adopts substantially the point of view of the Slain & Kripke article. The Report explains that, under subsection (a), "(i)f the security is an equity security, the damages or rescission claim is subordinated to all creditors and treated the same as the equity security itself." Id. at 359. The Report explains that subsection (b) "is intended to codify case law, such as Pepper v. Litton . . . and Taylor v. Standard Gas and Electric Co., 10 Cir., 96 F.2d 693 . . . and is not intended to limit the court's power in any way. The bankruptcy court will remain a court of equity . . . . The court's power is broader than the general doctrine of equitable subordination, and encompasses subordination on any equitable grounds." Id. In general, the Report notes that, "(t)he general creditors have not had the potential benefit of the proceeds of the enterprise deriving from ownership of securities and it is inequitable to permit shareholders that have had this potential benefit to shift the loss to general creditors." Id. at 195. Although it is plain that we

are not bound by this legislative activity, we find the reasoning behind it, supported by the Commission on the Bankruptcy Laws of the United States and the National Conference of Bankruptcy Judges, quite persuasive.

38 To decide in a way other than we decide today would not only violate our sense of simple fairness, it would unduly promote the policy of the federal securities laws to encourage full and fair corporate disclosure at the expense of the policy of Chapter X of the Bankruptcy Act to provide a "fair and equitable" distribution among the interested parties. This we decline to do.

39 The decision of the district court is affirmed.

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1 Homex was incorporated on July 22, 1968, under the laws of the State of Delaware; its offices and manufacturing plant were located in New York. Shortly after incorporation, Homex made a private offering of 1.6 million shares at $1 each. On February 19, 1970, 1,175,000 shares of Homex common stock were sold publicly for $16.50 per share, out of which the corporation realized approximately $6.1 million. On July 29, 1971, 500,000 shares of Homex cumulative convertible preferred stock were sold publicly at $40 per share, and the corporation realized approximately $19 million. The corporation acquired additional funds by borrowing approximately $38 million from a consortium of nine banks, some of which are appellees on this appeal

2 The Securities and Exchange Commission filed a civil injunctive action against Homex and its officers in the United States District Court for the District of Columbia on July 2, 1975, alleging that they had violated federal securities laws by issuing false and misleading financial statements. The defendants neither admitted nor denied the Commission's allegations, but instead consented to the entry of permanent injunctions against future violations. Criminal indictments were returned against five key Homex officials in 1976 in the Southern District of New York, charging them with securities fraud, mail fraud and conspiracy. After a six-week jury trial, each defendant was convicted of each charge. These convictions were affirmed by this Court. United States v. Stirling, 571 F.2d 708 (2d Cir. 1978), Petition for cert. filed, 46 U.S.L.W. 3723 (U.S. May 1, 1978)

3 Original jurisdiction over proceedings under Chapter X of the Bankruptcy Act is vested in the district courts of the United States as courts of bankruptcy. See 11 U.S.C. §§ 1(10), 11, 502

4 Mr. Frank Raichle, the Reorganization Trustee, originally intended to formulate a plan of reorganization under which Homex would continue operations. Borrowing proved impossible, however, as did merger with or acquisition by a financially sound company. He thus began the Herculean task of liquidating Homex's assets. See 11 U.S.C. § 616(10); Bankers Life & Cas. Co. v. Kirtley, 338 F.2d 1006, 1009-10 (8th Cir. 1964); 6A Collier on Bankruptcy P 10.19. Of the over 18,000 modules manufactured by Homex before the petition for reorganization was filed, more than half were unsold; by March 31, 1977, all but a few had been sold under approximately 382 separate contracts. Mr. Raichle also sold land, raw materials, machinery, equipment and other

assets and secured substantial federal and state tax refunds. As of May 31, 1977, Homex's unliquidated assets were estimated to be worth $3,749,634; cash and certificates of deposit amounted to $6,236,742. Finally, Mr. Raichle paid $7 million to the consortium of banks as an early and partial payment of the amount they will eventually receive under the reorganization plan. In exchange for this advance payment, the banks agreed to waive whatever security interests they had in Homex's assets security interests that Mr. Raichle disputed and to withdraw objections to the consolidation of the estates of Homex and its subsidiaries. Under this settlement, effected by court order, the banks assumed their present status as unsecured creditors

The debt figure of $45,961,000 represents the aggregate of claims against the Homex estate to which Mr. Raichle has not objected. It includes the approximately $38 million owed to the bank consortium, less the $7 million which has already been paid, but it excludes substantially all stockholder claims based on alleged violations of the federal securities laws. In addition to the banks' claims, there are a variety of secured and unsecured claims, claims by former employees for wages and expenses, and claims advanced by federal, state and local taxing authorities.

As of May 31, 1977, the estimated percentage distribution on the claims ranged between 30.46 percent and 34.81 percent absent any consideration for the stockholders' fraud claims.

5

On April 24, 1972, a class action complaint against Homex, its officers, and its auditors was filed by Homex stockholders in the United States District Court for the Southern District of New York alleging violations of federal securities laws and seeking damages. This complaint was eventually consolidated with other similar actions. The consolidated complaints alleged violations during the period of October 7, 1970, to July 10, 1972. See In Re Stirling Homex Securities Litigation, 388 F.Supp. 567 (Jud.Pan.Mult.Lit.1975). Because of a stay entered by Judge Burke prohibiting lawsuits against Homex, the consolidated complaint omitted the corporation as a defendant. See Bankruptcy Rule 10-601(a). On this appeal, the appellants note that "(t)he loss to shareholders, taking account of intermediate market fluctuations in excess of the offering prices, while difficult to estimate, could be as much as $100,000,000." Appellant's Brief at 5

Mr. Raichle received seven claims filed by stockholders containing allegations that Homex made false and misleading statements upon which they relied when purchasing Homex stock. The total amount of these claims was over $30 million. On July 24, 1975, however, Judge Burke disallowed so much of these claims as was made on behalf of a "class" of claimants virtually all of the claims. Judge Burke explained that there is no provision in the Bankruptcy Act for the filing of claims in a reorganization proceeding on behalf of a class, a ruling not contested on this appeal, and that the individual members of the purported class had failed to file claims within the period of time defined by a previously-issued order barring claims not made before February 19, 1973. What remained were six claims by allegedly defrauded stockholders totaling $21,869. Two of those claims, totaling $6,563, were filed by certain appellants in this appeal; none was filed by the remaining appellants. There is a dispute on this appeal as to whether the claims of the individual stockholders should be barred. The order read in part as follows: "All proofs of claim of creditors against the debtors or their property, of whatever character, either in tort or in contract, fixed or contingent, liquidated or unliquidated, other than those founded on . . . shares of stock, shall be filed with the Trustee of the debtors . . . on or before February 19, 1973." In view of our

disposition of the central issue on this appeal, we need not comment on the bar order.

6

Our appellate jurisdiction is based on § 24 of the Bankruptcy Act, 11 U.S.C. § 47, which provides as follows:

The United States courts of appeals . . . are invested with appellate jurisdiction from the several courts of bankruptcy in their respective jurisdictions in proceedings in bankruptcy, either interlocutory or final, and in controversies arising in proceedings in bankruptcy, to review, affirm, revise, or reverse, both in matters of law and in matters of fact . . . .

Except where inconsistent with Chapter X, the provisions of § 24 are applicable to appeals generated by reorganization proceedings. See 11 U.S.C. § 521; In Re Wingreen Co., 412 F.2d 1048, 1050-51 (5th Cir. 1969); 2 Collier on Bankruptcy P 24.45; 6 Collier on Bankruptcy P 3.40. "Under the present Act, the general rule is that an appeal from an order or decree entered in a 'proceeding in bankruptcy', either interlocutory or final, may be taken as of right, without any necessity for the securing of an allowance from the court of appeals." 2 Collier on Bankruptcy P 24.11(3) (footnote omitted). Judge Burke's order subordinating the stockholders' claims to the more conventional unsecured creditors' claims was issued during a "proceeding in bankruptcy." See id. at PP 24.12, 24.19.

7

The rule reads as follows:

For the purposes of the plan and its acceptance, the court may fix, after hearing on such notice as it may direct, the division of creditors and stockholders into classes according to the nature of their respective claims and stock.

8

The Supreme Court has, on two occasions, left this question unanswered. See Protective Committee v. Anderson, 390 U.S. 414, 423 & n. 8, 453, 88 S.Ct. 1157, 20 L.Ed.2d 1 (1968); Tcherepnin v. Knight, 389 U.S. 332, 346, 88 S.Ct. 548, 19 L.Ed.2d 564 (1967). We do not consider the 1939 decision of Oppenheimer v. Harriman National Bank & Trust Co., 301 U.S. 206, 57 S.Ct. 719, 81 L.Ed. 1042 (1937), upon which the stockholders in this dispute rely, to be of controlling significance in Chapter X reorganization efforts. Mr. Oppenheimer bought stock in the Harriman bank in 1930. The bank closed in 1933, and, while it was being liquidated by the Comptroller of the Currency, Oppenheimer sued for rescission based on a claim of fraud and secured a money judgment for the amount he paid for his shares. The Second Circuit ordered that the judgment be paid only "after payment of all who were creditors when the bank became insolvent." 85 F.2d 582, 585. The Supreme Court reversed, holding that Oppenheimer's "judgment is entitled to rank on a parity with other unsecured creditors' claims." 301 U.S. at 215, 57 S.Ct. at 724 (footnote omitted). Significantly, the Oppenheimer decision, based on facts that occurred prior to federal securities legislation, was made not pursuant to the Bankruptcy Act but under an entirely different statutory scheme the National Bank Act, 12 U.S.C. § 1 Et seq. under which distribution is to be "ratable" rather than "fair and equitable." See 12 U.S.C. § 194

There are, of course, a number of cases in which Trustees in Chapter X proceedings, faced with

colorable claims made by allegedly defrauded stockholders, have decided to settle or compromise rather than litigate the position of such claimants. See In Re Equity Funding Corp. of America, 416 F.Supp. 132, 151 (D.C.Cal.), Aff'd, 519 F.2d 1274 (9th Cir. 1975); Huff, The Defrauded Investor in Chapter X Reorganizations: Absolute Priority v. Rule 10b-5, 50 Am.Bankr.L.J. 197, 215 (1976). The stockholders on this appeal admit, however, that there are no rulings that mandate parity participation in a reorganization plan by allegedly defrauded stockholders over a trustee's objection.

TAB 4

Re Blue Range Resource Corporation, 2000 ABQB 4

Date: 20000110
Action No. 9901-04070

IN THE COURT OF QUEEN'S BENCH OF ALBERTA
JUDICIAL DISTRICT OF CALGARY

IN THE MATTER OF THE COMPANIES' CREDITORS ARRANGEMENT ACT, R.S.C. 1985, C. C-36, AS AMENDED

AND IN THE MATTER OF BLUE RANGE RESOURCE CORPORATION

APPEARANCES:

R.J. (Bob) Wilkins/Gary Befus of Walsh Wilkins
for Big Bear Exploration Ltd.

A. Robert Anderson/Bryan Duguid of Blake Cassels & Graydon
for Enron Trade & Capital Resources Canada Corp.

Glen H. Poelman of Macleod Dixon
for the Creditors' Committee

Virginia A. Engel of Peacock Linder & Halt
for MRF 1998 II Limited Partnership

REASONS FOR JUDGMENT
of the
HONOURABLE MADAM JUSTICE B.E. ROMAINE

INTRODUCTION

[1] This is an application for determination of three preliminary issues relating to a claim made by Big Bear Exploration Ltd. against Blue Range Resource Corporation, a company to which the Companies' Creditors Arrangement Act, R.S.C. 1985, c.C-36, as amended, applies. Big Bear is the sole shareholder of Blue Range, and submits that its claim should rank equally with claims of unsecured creditors. The preliminary issues relate to the ranking of Big Bear's claim, the scope of its entitlement to pursue its claim and whether Big Bear is the proper party to advance the major portion of the claim.

[2] The Applicants are the Creditors' Committee of Blue Range and Enron Canada Corp., a major creditor. Big Bear is the Respondent, together with the MRF 1998 II Limited Partnership, whose partners are in a similar situation to Big Bear.

FACTS

[3] Between October 27, 1998 and February 2, 1999, Big Bear took the following steps:

(a) it purchased shares of Blue Range for cash through The Toronto Stock Exchange on October 27 and 29, 1998;

(b) it undertook a hostile takeover bid on November 13, 1998, by which it sought to acquire all of the issued and outstanding Blue Range shares;

(c) it paid for the Blue Range shares sought through the takeover bid by way of a share exchange: Blue Range shareholders accepting Big Bear's offer received 11 Big Bear shares for each Blue Range share;

(d) it issued Big Bear shares from treasury to provide the shares used in the share exchange.

[4] The takeover bid was accepted by Blue Range shareholders and on December 12, 1998, Big Bear acquired control of Blue Range. It is now the sole shareholder of Blue Range.

[5] Big Bear says that its decision to undertake the takeover was made in reliance upon information publicly disclosed by Blue Range regarding its financial situation. It says that after the takeover, it discovered that the information disclosed by Blue Range was misleading, and in fact the Blue Range shares were essentially worthless.

[6] Big Bear as the sole shareholder of Blue Range entered into a Unanimous Shareholders' Agreement pursuant to which Big Bear replaced and took on all the rights, duties and obligations of the Blue Range directors. Using its authority under the Unanimous Shareholders' Agreement, Big Bear caused Blue Range to apply for protection under the CCAA. An order stipulating that Blue Range is a company to which the CCAA applies was granted on March 2, 1999.

[7] On April 6, 1999, LoVecchio, J. issued an order which provides, in part, that:

(a) all claims of any nature must be proved by filing with the Monitor a Notice of Claim with supporting documentation, and

(b) claims not received by the Monitor by May 7, 1999, or not proved in accordance with the prescribed procedures, are forever barred and extinguished.

[8] Big Bear submitted a Notice of Claim to the Monitor dated May 5, 1999 in the amount of $151,317,298 as an unsecured claim. It also filed a Notice of Motion on May 5, 1999, seeking an order lifting the stay of proceedings granted by the March 2, 1999 order for the purpose of filing a statement of claim against Blue Range. Big Bear's application for leave to file its statement of claim was denied by LoVecchio, J. on May 11, 1999.

[9] On May 21, 1999, the Monitor issued a Notice of Dispute disputing in full the Big Bear claim. Big Bear filed a Notice of Motion on May 31, 1999 for:

(a) a declaration that the unsecured claim of Big Bear is a meritorious claim against Blue Range; and

(b) an order directing the expeditious trial and determination of the issues raised by the unsecured claim of Big Bear.

[10] On October 4, 1999, LoVecchio, J. directed that there be a determination of two issues in respect of the Big Bear unsecured claim by way of a preliminary application. On October 28, 1999, I defined the two issues and added a third one.

[11] Big Bear's Notice of Claim sets out the nature and amount of its claim against Blue Range. The amount is particularized by the schedule attached to the Notice of Claim, which identifies the claim as being comprised of the following components:

(a) the price of shares acquired for cash on October 27 and 29, 1998 ($724,454.91);
(b) the value of shares acquired by means of the share exchange of Big Bear treasury shares for Blue Range shares held by Blue Range shareholders ($147,687,298); and
(c) "transaction costs," being costs incurred by Big Bear for consultants, professional advisers, filings, financial services, and like matters incidental to the share purchases generally, and the takeover bid in particular ($3,729,498).

ISSUE #1

[12] With respect to the alleged share exchange loss, without considering the principle of equitable subordination, is Big Bear:

(a) an unsecured creditor of Blue Range that ranks equally with the unsecured creditors of Blue Range; or
(b) a shareholder of Blue Range that ranks after the unsecured creditors of Blue Range.

[13] At the hearing, this question was expanded to include reference to the transaction costs and cash share purchase damage claims in addition to the alleged share exchange loss.

Summary of Decision

[14] The nature of the Big Bear claim against Blue Range for an alleged share exchange loss, transaction costs and cash share purchase damages is in substance a claim by a shareholder for a return of what it invested *qua* shareholder. The claim therefore ranks after the claims of unsecured creditors of Blue Range.

Analysis

[15] The position of the Applicants is that the share exchange itself was clearly an investment in capital, and that the claim for the share exchange loss derives solely from and is inextricably intertwined with Big Bear's interest as a shareholder of Blue Range. The Applicants submit that there are therefore good policy reasons why the claim should rank after the claims of unsecured creditors of Blue Range, and that basic corporate principles, fairness and American case law support these policy reasons. Big Bear submits that its claim is a tort claim, allowable under the

CCAA, and that there is no good reason to rank the claim other than equally with unsecured creditors. Big Bear submits that the American cases cited are inappropriate to a Canadian CCAA proceeding, as they are inconsistent with Canadian law.

[16] There is no Canadian law that deals directly with the issue of whether a shareholder allegedly induced by fraud to purchase shares of a debtor corporation is able to assert its claim in such a way as to achieve parity with other unsecured creditors in a CCAA proceeding. It is therefore necessary to start with basic principles governing priority disputes.

[17] It is clear that in common law shareholders are not entitled to share in the assets of an insolvent corporation until after all the ordinary creditors have been paid in full: *Re: Central Capital Corp.* (1996), 132 D.L.R. (4th) 223 (Ont. C.A.) at page 245; *Canada Deposit Insurance Corp. v. Canadian Commercial Bank* (1992), 97 D.L.R. (4th) 385 (S.C.C.) at pages 402 and 408. In that sense, Big Bear acquired not only rights but restrictions under corporate law when it acquired the Blue Range shares.

[18] There is no doubt that Big Bear has exercised its rights as a shareholder of Blue Range. Pursuant to the Unanimous Shareholders' Agreement, it authorized Blue Range to file an application under the CCAA "to attempt to preserve the equity value of [Blue Range] for the benefit of the sole shareholder of [Blue Range]" (Bourchier November 1, 1999 affidavit). It now attempts to recover its alleged share exchange loss through the claims approval process and rank with unsecured creditors on its claim. The issue is whether this is a collateral attempt to obtain a return on an investment in equity through equal status with ordinary creditors that could not be accomplished through its status as a shareholder.

[19] In *Canada Deposit Insurance* (supra), the Supreme Court of Canada considered whether emergency financial assistance provided to the Canadian Commercial Bank by a group of lending institutions and government was properly categorized as a loan or as an equity investment for the purpose of determining whether the group was entitled to rank *pari passu* with unsecured creditors in an insolvency. The court found that, although the arrangement was hybrid in nature, combining elements of both debt and equity, it was in substance a loan and not a capital investment. It is noteworthy that the equity component of the arrangement was incidental, and in fact had never come into effect, and that the agreements between the parties clearly supported the characterization of the arrangement as a loan.

[20] *Central Capital* (*supra*) deals with the issue of whether the holders of retractable preferred shares should be treated as creditors rather than shareholders under the CCAA because of the retraction feature of the shares. Weiler, J.A. commented at page 247 of the decision that it is necessary to characterize the true nature of a transaction in order to decide whether a claim is a claim provable in either bankruptcy or under the CCAA. She stated that a court must look to the surrounding circumstances to determine "whether the true nature of the relationship is that of a shareholder who has equity in the company or whether it is that of a creditor owed a debt or liability."

[21] The court in *Central Capital* found that the true nature of the relationship between the preferred shareholders and the debtor company was that of shareholders. In doing so, it considered the statutory provision that prevents a corporation from redeeming its shares while insolvent, the articles of the corporation, and policy considerations. In relation to the latter factor, the court commented that in an insolvency where debts will exceed assets, the policy of federal insolvency legislation precludes shareholders from looking to the assets until the creditors have been paid (*supra*, page 257).

[22] In this case, the true nature of Big Bear's claim is more difficult to characterize. There may well be scenarios where the fact that a party with a claim in tort or debt is a shareholder is coincidental and incidental, such as where a shareholder is also a regular trade creditor of a corporation, or slips and falls outside the corporate office and thus has a claim in negligence against the corporation. In the current situation, however, the very core of the claim is the acquisition of Blue Range shares by Big Bear and whether the consideration paid for such shares was based on misrepresentation. Big Bear had no cause of action until it acquired shares of Blue Range, which it did through share purchases for cash prior to becoming a majority shareholder, as it suffered no damage until it acquired such shares. This tort claim derives from Big Bear's status as a shareholder, and not from a tort unrelated to that status. The claim for misrepresentation therefore is hybrid in nature and combines elements of both a claim in tort and a claim as shareholder. It must be determined what character it has in substance.

[23] It is true that Big Bear does not claim recission. Therefore, this is not a claim for return of capital in the direct sense. What is being claimed, however, is an award of damages measured as the difference between the "true" value of Blue Range shares and their "misrepresented" value - in other words, money back from what Big Bear "paid" by way of consideration. Although the matter is complicated by reason that the consideration paid for Blue Range shares by Big Bear was Big Bear treasury shares, the Notice of Claim filed by Big Bear quantifies the loss by assigning a value to the treasury shares. A tort award to Big Bear could only represent a return of what Big Bear invested in equity of Blue Range. It is that kind of return that is limited by the basic common law principal that shareholders rank after creditors in respect of any return on their equity investment. Whether payment of the tort liability by Blue Range would affect Blue Range's stated capital account is irrelevant, since the shares were not acquired from Blue Range but from its shareholders.

[24] In considering the question of the characterization of this claim, it is noteworthy that Mr. Tonken in his March 2, 1999 affidavit in support of Blue Range's application to apply the CCAA did not include the Big Bear claim in his list of estimated outstanding debt, accounts payable and other liabilities. The affidavit does, however, set out details of the alleged mispresentations.

[25] I find that the alleged share exchange loss derives from and is inextricably intertwined with Big Bear's shareholder interest in Blue Range. The nature of the claim is in substance a claim by a shareholder for a return of what it invested *qua* shareholder, rather than an ordinary tort claim.

[26] Given the true nature of the claim, where should it rank relative to the claims of unsecured

creditors?

[27] The CCAA does not provide a statutory scheme for distribution, as it is based on the premise that a Plan of Arrangement will provide a classification of claims which will be presented to creditors for approval. The Plan of Arrangement presented by CNRL in the Blue Range situation has been approved by creditors and sanctioned by the Court. Section 3.1 of the Plan states that claims shall be grouped into two classes: one for Class A Claimants and one for Class B Claimants, which are described as claimants that are "unsecured creditors" within the meaning of the CCAA, but do not include " a Person with a Claim which, pursuant to Applicable Law, is subordinate to claims of trade creditors of any Blue Range Entities." The defined term "Claims" includes indebtedness, liability or obligation of any kind. Applicable Law includes orders of this Court.

[28] Although there are no binding authorities directly on point on the issue of ranking, the Applicants submit that there are a number of policy reasons for finding that the Big Bear claim should rank subordinate to the claims of unsecured creditors.

[29] The first policy reason is based on the fundamental corporate principle that claims of shareholders should rank below those of creditors on an insolvency. Even though this claim is a tort claim on its face, it is in substance a claim by a shareholder for a return of what it paid for shares by way of damages. The Articles of Blue Range state that a holder of Class A Voting Common Shares is entitled to receive the "remaining property of the corporation upon dissolution in equal rank with the holders of all other common shares of the Corporation". As pointed out by Laskin, J. in *Central Capital (supra* at page 274):

> Holding that the appellants do not have provable claims accords with sound corporate policy. On the insolvency of a company the claims of creditors have always ranked ahead of the claims of shareholders for the return of their capital. Case law and statute law protect creditors by preventing companies from using their funds to prejudice creditors' chances of repayment. Creditors rely on these protections in making loans to companies.

[30] Although what is envisaged here is not that Blue Range will pay out funds to retract shares, the result is the same: Blue Range would be paying out funds to the benefit of its sole shareholder to the prejudice of third-party creditors.

[31] It should be noted that this is not a case, as in the recent restructuring of Eatons under the CCAA, where a payment to the shareholders was clearly set out in the Plan of Arrangement and approved by the creditors and the court.

[32] As counsel for Engage Energy, one of the trade creditors, stated on May 11, 1999 during Big Bear's application for an order lifting the stay order under the CCAA and allowing Big Bear to file a statement of claim:

> We've gone along in this process with a general understanding in our mind as to what the creditor pool is, and as rece tly as middle of April, long after the evidence will show that Big Bear was identifying in its own mind the existence of this claim, public statements were continuing to be made, setting out the creditor pool, which did not include this claim. And this makes a significant difference in how people react to supporting an ongoing plan...

[33] Another policy reason which supports subordinating the Big Bear claim is a recognition that creditors conduct business with corporations on the assumption that they will be given priority over shareholders in the event of an insolvency. This assumption was referred to by Laskin, J. in *Central Capital (supra)*, in legal textbooks (Hadden, Forbes and Simmonds, Canadian Business Organizations Law Toronto: Butterworths, 1984 at 310, 311), and has been explicitly recognized in American case law. The court in *In the Matter of Stirling Homex Corporation*, 579 F. 2d 206 (1978) U.S.C.A. 2nd Cir. at page 211 referred to this assumption as follows:

> Defrauded stockholder claimants in the purchase of stock are presumed to have been bargaining for equity type profits and assumed equity type risks. Conventional creditors are presumed to have dealt with the corporation with the reasonable expectation that they would have a senior position against its assets, to that of alleged stockholder claims based on fraud.

[34] The identification of risk-taking assumed by shareholders and creditors is not only relevant in a general sense, but can be illustrated by the behaviour of Big Bear in this particular case. In the evidence put before me, Big Bear's president described how, in the course of Big Bear's hostile takeover of Blue Range, it sought access to Blue Range's books and records for information, but had its requests denied. Nevertheless, Big Bear decided to pursue the takeover in the absence of information it knew would have been prudent to obtain. Should the creditors be required to share the result of that type of risk-taking with Big Bear? The creditors are already suffering the results of misrepresentation, if it occurred, in the inability of Blue Range to make full payment on its trade obligations.

[35] The Applicants submit that a decision to allow Big Bear to stand *pari passu* with ordinary creditors would create a fundamental change in the assumptions upon which business is carried on between corporations and creditors, requiring creditors to re-evaluate the need to obtain secured status. It was this concern, in part, that led the court in *Stirling Homex* to find that it was fair and equitable that conventional creditors should take precedence over defrauded shareholder claims (*supra* at page 208).

[36] The Applicants also submit that the reasoning underlying the *Central Capital* case (where the court found that retraction rights in shares do not create a debt that can stand equally with the debt of shareholders) and the cases where shareholders have attempted to rescind their shareholdings after a corporation has been found insolvent is analogous to the Big Bear situation, and the same result should ensue.

[37] It is clear that, both in Canada and in the United Kingdom, once a company is insolvent, shareholders are not allowed to rescind their shares on the basis of misrepresentation: *McAskill v. The Northwestern Trust Company*, [1926] S.C.R. 412 at 419; *Milne v. Durham Hosiery Mills Ltd.*, [1925] 3 D.L.R. 725 (Ont. S.C.A.D.); *Trusts and Guarantee Co. v. Smith* (1923), 54 O.L.R. 144 (Ont. S.C.A.D.); *Re: National Stadium Ltd.* (1924), 55 O.L.R. 199 (Ont. S.C.); *Oaks v. Turquend* [1861-73] All E.R. Rep. 738 (H.L.) at page 743-744.

[38] The court in *McAskill (supra* at page 419) in obiter dicta refers to a claim of recission for fraud, and comments that the right to rescind in such a case may be lost due to a change of circumstances making it unjust to exercise the right. Duff, J. then refers to the long settled principle that a shareholder who has the right to rescind his shares on the ground of misrepresentation will lose that right if he fails to exercise it before the commencement of winding-up proceedings, and comments:

> The basis of this is that the winding-up order creates an entirely new situation, by altering the relations, not only between the creditors and the shareholders, but also among the shareholders *inter se*.

[39] This is an explicit recognition that in an insolvency, a corporation may not be able to satisfy the claims of all creditors, thus changing the entire complexion of the corporation, and rights that a shareholder may have been entitled to prior to an insolvency can be lost or limited.

[40] In the Blue Range situation, Big Bear has actively embraced its shareholder status despite the allegations of misrepresentation, putting Blue Range under the CCAA in an attempt to preserve its equity value and, in the result, holding Blue Range's creditors at bay. Through the provision of management services, Big Bear has participated in adjudicating on the validity of creditor claims, and has then used that same CCAA claim approval process to attempt to prove its claim for misrepresentation. It may well be inequitable to allow Big Bear to exercise all of the rights it had arising from its status as shareholder before CCAA proceedings had commenced without recognition of Blue Range's profound change of status once the stay order was granted. Certainly, given the weight of authority, Big Bear would not likely have been entitled to rescind its purchase of shares on the basis of misrepresentation, had the Blue Range shares been issued from treasury.

[41] Finally, the Applicants submit that it is appropriate to take guidance from certain American cases which are directly on point on this issue.

[42] The question I was asked to address expressly excludes consideration of the principle of "equitable subordination". The Applicants submit that the principle of equitable subordination that is excluded for the purpose of this application is the statutory principle codified in the U.S. Bankruptcy Code in 1978 (Bankruptcy Code, Rules and Forms (1999 Ed.) West Group, Subchapter 1, Section 510 (b)). This statutory provision requires notice and a full hearing, and relates to the ability of a court to subordinate an allowed claim to another claim using the principles of equitable subordination set out and defined in case law. The Applicants submit,

however, that I should look to three American cases that preceded this statutory codification and that dealt with subordination of claims by defrauded shareholders to the claims of ordinary unsecured creditors on an equitable basis.

[43] The first of these cases is *Stirling Homex (supra)*. The issue dealt with by the United States Court of Appeals, Second Circuit, is directly on point: whether claims filed by allegedly defrauded shareholders of a debtor corporation should be subordinated to claims filed by ordinary unsecured creditors for the purposes of formulating a reorganization plan. The court referred to the decision of *Pepper v. Litton* (308 U.S. 295 at page 305, 60 S.Ct. 238, 84 L. Ed. 281 (1939)) where the Supreme Court commented that the mere fact that a shareholder has a claim against the bankrupt company does not mean it must be accorded *pari passu* status with other creditors, and that the subordination of that claim may be necessitated by principles of equity. Elaborating on this, the court in *Stirling Homex* (*supra* at page 213) stated that where the debtor corporation is insolvent, the equities favour the general creditors rather than the allegedly defrauded shareholders, since in this case, the real party against which the shareholders are seeking relief is the general creditors whose percentage of realization will be reduced if relief is given to the shareholders. The court quotes a comment made by an earlier Court of Appeals (*Newton National Bank v. Newbegin*, 74 F. 135, 140 (8th Cir. 1896):

> When a corporation becomes bankrupt, the temptation to lay aside the garb of a stockholder, on one pretense or another, and to assume the role of creditor, is very strong, and all attempts of that kind should be viewed with suspicion.

[44] Although the court in *Stirling Homex* refers to its responsibility under US bankruptcy law to ensure that a plan of reorganization is "fair and equitable" and to the "absolute priority" rule of classification under US bankruptcy principles, it is clear that the basis for its decision is the general rule of equity, a "sense of simple fairness" (*supra*, page 215). Despite the differences that may exist between Canadian and American insolvency law in this area, this case is persuasive for its reasoning based on equitable principles.

[45] If Big Bear's claim is allowed to rank equally with unsecured creditors, this will open the door in many insolvency scenarios for aggrieved shareholders to claim misrepresentation or fraud. There may be many situations where it could be argued that there should have been better disclosure of the corporation's declining fortunes, for who would deliberately have invested in a corporation that has become insolvent. Although the recognition that this may greatly complicate the process of adjudicating claims under the CCAA is not of itself sufficient to subordinate Big Bear's claim, it is a factor that may be taken into account.

[46] The Applicants also cite the case of *In re U.S. Financial Incorporated* 648 F. 2d 515 (1980)(U.S.C.A. 9th Cir.). This case is less useful, as it was decided primarily on the basis of the absolute priority rule, but while the case was not decided on equitable grounds, the court commented that support for its decision was found in the recognition of the importance of recognizing differences in expectations between creditors and shareholders when classifying claims (*supra* at page 524). The court also stated that although both creditors and shareholders had

been victimized by fraud, it was equitable to impose the risks of insolvency and illegality on the shareholders whose investment, by its very nature, was a risky one.

[47] The final case cited to me on this issue is *In re THC Financial* 679 F. 2d 784 (1982) (U.S.C.A. 9th Cir.), where again the court concluded that claims of defrauded shareholders must be subordinated to the claims of the general creditors. The court commented that the claimant shareholders had bargained for equity-type profits and equity-type risks in purchasing their shares, and one such risk was the risk of fraud. As pointed out previously, Big Bear had an appreciation of the risks of proceeding with its takeover bid without access to the books and records of Blue Range and took the deliberate risk of proceeding in any event.

[48] In *THC Financial*, the claimants argued that since they had a number of possible causes of action in addition to their claim of fraud, they should not subordinated merely because they were shareholders. The court found, however, that their claim was essentially that of defrauded shareholders and not as victims of an independent tort. All of the claimants' theories of recovery were based on the same operative facts - the fraudulent scheme.

[49] Big Bear submits that ascribing some legal impediment to a shareholder pursuing a remedy in tort against a company in which it holds shares violates the principle set out in *Salomon v. Salomon and Company, Limited* [1897] A.C. 22 (H.L.) that corporations are separate and distinct entities from their shareholders. In my view, this is not in issue. What is being sought here is not to limit a tort action by a shareholder against a corporation but to subordinate claims made *qua* shareholder to claims made by creditors in an insolvency situation. That shareholder rights with respect to claims against a corporation are not unlimited has already been established by the cases on rescission and recognized by statutory limitations on redemption and retraction. In this case, the issue is not the right to assert the claim, but the right to rank with creditors in the distribution of the proceeds of a pool of assets that will be insufficient to cover all claims. No piercing of the corporate veil is being suggested or would result.

[50] Counsel for Big Bear cautions against the adoption of principles set out in the American cases on the basis that some decisions on equitable subordination require inequitable conduct by the claimant as a precondition to subordinating a claim, referring to a three-part test set out in a number of cases. This discussion of the inequitable conduct precondition takes place in the broader context of equitable subordination for any cause as it is codified under Section 510 of the US Bankruptcy Code. In any event, it appears that more recent American cases do not restrict the use of equitable subordination to cases of claimant misconduct, citing, specifically, that stock redemption claims have been subordinated in a number of cases even when there is no inequitable conduct by the shareholder. "Stock redemption" is the term used for cases involving fraud or misrepresentation: *U.S. v. First Truck Lines, Inc.* (1996) 517 U.S. 535; *SPC Plastics Corporation et al v. Griffiths et al* (1998) 6th Circuit Case No. 88-21236. Some of the American cases draw a distinction between cases where misconduct is generally required before subordination will be imposed and cases where "the claim itself is of a status susceptible to subordination, such as...a claim for damages arising from the purchase ... of a security of the debtor": *U.S. v. First Truck Lines, Inc. (supra,* at paragraph 542).

[51] The issue of whether equitable subordination as codified in Section 510 of the U.S. Bankruptcy Code should form part of the law in Canada has been raised in several cases but left undecided. Big Bear submits that these cases establish that if equitable subordination is to be part of Canadian law, it should be on the basis of the U.S. three-part test which includes the condition of inequitable conduct. Again, I cannot accept this submission. It is true that Iacobucci, J. in *Canada Deposit Insurance Corp.*, while he expressly refrains from deciding whether a comparable doctrine should exist in Canada, refers to the three-part test and states that he does not view the facts of the *Canada Deposit Insurance Corp.* case as giving rise to inequitable conduct. It should be noted, however, that that case did not involve a claim by a shareholder at all, since the lenders had never received the securities that were an option under the agreements, and that the relationship had at this point in the case been characterized as a debtor/creditor relationship.

[52] At any rate, this case, together with *Olympia and York Developments Ltd. v. Royal Trust Co.* [1993] O.J. No. 181 (Ont. G.D.) and *Unisource Canada Inc. v. HongKong Bank of Canada* [1998] O.J. No. 5586 (Ont. H.C.) all refer to the doctrine of equitable subordination codified in the U.S. Bankruptcy Code which is not in issue here. The latter two cases appear to have accepted the erroneous proposition that inequitable misconduct is required in all cases under the American doctrine.

[53] Big Bear also submits that the equitable principles that exist in U.S. law which have led the courts to ignore separate corporate personality in the case of subsidiary corporations are related to equitable principles used to subordinate shareholder claims. The basis for this submission appears to be a reference by the British Columbia Court of Appeal in *B.G. Preeco I (Pacific Coast) Ltd. v. Bon Street Holdings Ltd. et al* (1989) 43 B.L.R. 68 (1989) to the *Pepper v. Litton* case (*supra*) and the so-called "Deep Rock doctrine" under American law. I do not see a link between the comments made in *Pepper v. Litton* and referred to in *B.C. Preeco* on an entirely different issue and comments concerning the court's equitable jurisdiction in the case of claims by shareholders against insolvent corporations.

[54] I acknowledge that caution must be used in following the approach taken in American cases to ensure that the principles underlying such approach do not arise from differences between U.S. and Canadian law. However, I find that the comments made by the American courts in these cases relating to the policy reasons for subordinating defrauded shareholder claims to those of ordinary creditors are persuasive, as they are rooted in principles of equity that are very similar to the equitable principles used by Canadian courts.

[55] American cases are particularly useful in the areas of commercial and insolvency law given that the larger economy in the United States generates a wider variety of issues that are adjudicated by the courts. There is precedent for the use of such cases: Laskin, J. in *Central Capital Corp.* (*supra*) used the analysis set out in American case law on whether preferred shareholders can claim as creditors in an insolvency to help him reach his conclusion.

[56] The three American cases decided on this direct issue before the 1978 statutory

codification of the law of equitable subordination are not based on a doctrine of American law that is inconsistent with or foreign to Canadian common law. It is not necessary to adopt the U.S. absolute priority rule to follow the approach they espouse, which is based on equitable principles of fairness and policy. There is no principled reason to disregard the approach set out in these cases, which have application to Canadian business and economy, and I have found them useful in considering this issue.

[57] Based on my characterization of the claim, the equitable principles and considerations set out in the American cases, the general expectations of creditors and shareholders with respect to priority and assumption of risk, and the basic equitable principle that claims of defrauded shareholders should rank after the claims of ordinary creditors in a situation where there are inadequate assets to satisfy all claims, I find that Big Bear must rank after the unsecured creditors of Blue Range in respect to the alleged share exchange loss, the claim for transaction costs and the claim for cash share purchase damages.

ISSUE #2

[58] Assuming (without admitting) misrepresentation by Blue Range and reliance on it by Big Bear, is the alleged share exchange loss a loss or damage incurred by Big Bear and, accordingly, is Big Bear a proper party to advance the claim for such a loss?

Summary of Decision

[59] As the alleged share exchange loss is not a loss incurred by Big Bear, Big Bear is not the proper party to advance this claim.

Analysis

[60] The Applicants submit that negligence is only actionable if a plaintiff can prove that it suffered damages, as the purpose of awarding damages in tort is to compensate for actual loss. This is a significant difference between damages in tort and damages in contract. In order for a plaintiff to have a cause of action in negligent misrepresentation, it must satisfy the court as to the usual elements of duty of care and breach thereof, and it must establish that it has sustained damages from that breach.

[61] The Applicants argue that Big Bear did not suffer any damages arising from the share exchange. The Big Bear shares used in the share exchange came from treasury: Big Bear did not use any corporate funds or corporate assets to purchase the Blue Range shares. As the shares used in the exchange did not exist prior to the transaction, Big Bear was essentially in the same financial position pre-issuance as it was post-issuance in terms of its assets and liabilities. The nature and composition of Big Bear's assets did not change as the treasury shares were created and issued for the sole purpose of the share exchange. Therefore, Big Bear did not sustain a loss in the amount of the value of the shares. The Applicants submit that the only potential loss is that of the pre-takeover shareholders of Big Bear, as the value of their shares may have been diluted as a

result of the share exchange. However, even if there was such a loss, Big Bear is not the proper party to pursue such an action. Just as shareholders may not bring an action for a loss which properly belongs to the corporation, a corporation may not bring an action for a loss directly incurred by its shareholders.

[62] Big Bear claims that it is entitled to recover the value of the Big Bear shares that were issued in furtherance of the share exchange. It says that it can prove all the elements of negligent misrepresentation: there was a special relationship; material misrepresentations were made to Big Bear; those representations were made negligently; Big Bear relied on those representations; and Big Bear suffered damage.

[63] It submits that damages for negligent misrepresentation are calculated as the difference between the represented value of the shares less their sale value. Big Bear contends that it matters not that the consideration for the Blue Range shares was Big Bear shares issued from treasury. As long as the consideration is adequate consideration for legal purposes, its form does not affect the measure of damages awarded by the courts for negligent misrepresentation. Big Bear says that it bargained for a company with a certain value, and, in doing so, it gave up its own shares worth that value. Therefore, Big Bear submits that it clearly incurred a loss.

[64] Big Bear submits that it is the proper party to pursue this head of damages. While the corporation has met the test for negligent misrepresentation, the shareholders likely could not, as the representations in questions were not made to them. In any event, Big Bear indicates that it does not claim for any damages caused by dilution of the shares. It also notes that a claim for dilution would not be the same as the face value of the shares issued in the share exchange, which is the amount claimed in the Notice of Claim.

[65] Big Bear's claim is in tort, not contract. This is an important distinction, as the issue at hand concerns the measure of damages. The measure of damages is not necessarily the same in contract as it is in tort.

[66] It is a first principle of tort law that a person is entitled to be put in the position, insofar as possible, that he or she was before the tort occurred. While the courts were historically loath to award damages for pure economic loss, this position was softened in ***Hedley Byrne & Co. Ltd.* v. *Heller & Partners Ltd.*, [1964] A.C. 465 (H.L.)** where the court confirmed that damages could be recovered in this type of case. When assessing damages for negligent misrepresentation resulting in pure economic loss, the goal is to put the party who relied on the misrepresentation in the position which it would have been in had the misrepresentation not occurred. While the parties to this application appear to agree on this principle, it is the application thereof with which they disagree.

[67] The proper measure of damages in cases of misrepresentation is discussed in **S.M. Waddams, *The Law of Damages* (Toronto: Canada Law Book Inc., Looseleaf, Dec. 1998),** where the author states:

The English and Canadian cases have consistently held that the proper measure [with respect to fraudulent misrepresentation] is the tortious measure, that is the amount of money required to put the plaintiff in the position that would have been occupied not if the statement had been true but if the statement had not been made. The point was made clearly in *McConnel v. Wright*, [1903] 1 Ch. 546 (C.A.):

> It is not an action for breach of contract, and, therefore, no damages in respect of prospective gains which the person contracting was entitled by his contract to expect come in, but it is an action of tort - it is an action for a wrong done whereby the plaintiff was tricked out of certain money in his pocket; and therefore, prima facie, the highest limit of his damages is the whole extent of his loss, and that loss is measured by the money which was in his pocket and is now in the pocket of the company. That is the ultimate, final, highest standard of his loss. (at 5-19, 5-20)

...

Since the decision of the House of Lords in 1963 in *Hedley Byrne Ltd.* v. *Heller & Partners Ltd.,* [1964] A.C. 465 (H.L.) it has been established that an action lies for negligent misrepresentation causing economic loss. It naturally follows from acceptance of out-of pocket loss rather than the contractual measure as the basic measure of damages for fraud, that the same basic measure applies to negligent misrepresentation. (at 5-28).

[68] Big Bear claims to be entitled to the difference between the actual value and the exchange value of the shares. The flaw in this assertion is that it focuses on what Big Bear bargained for as opposed to what it actually received, which is akin to a contractual measure of damages. Big Bear clearly states that it is not maintaining an action in contract, only in tort. Damages in tort are limited to the losses which a plaintiff *actually incurs* as a result of the misrepresentation. Thus, Big Bear is not entitled to recover what it expected to receive as a result of the transaction; it is entitled to be compensated only for that which it actually lost. In other words, what did Big Bear have before the loss which it did not have afterwards? To determine what losses Big Bear actually sustained, its position after the share exchange must be compared with its position prior to the share exchange.

[69] The situation at hand is unique. Due to a negligent misrepresentation, Big Bear was induced to give up something which, although it had value, was of substantially no cost to the corporation, and in fact did not even exist but for the misrepresentation. Big Bear created shares which had a value for the purpose of the share exchange, in that Blue Range shareholders were willing to accept them in exchange for Blue Range shares. However, outside of transaction costs, those shares had no actual cost to Big Bear, as compared to the obvious costs associated with a payment by way of cash or tangible assets. Big Bear cannot say that after the share exchange, it had lost approximately $150 million dollars, because the shares essentially did not exist prior to the transaction, and the cost of creating those shares is not equivalent to their face value. Big Bear retains the ability to issue a limitless number of shares from treasury in the future; any loss in this regard would not be equivalent to the actual value of the shares. Therefore, all that is required to return Big Bear to its pre-misrepresentation position is compensation for the actual costs associated with issuing the shares.

[70] That Big Bear has not incurred a loss in the face value of the exchanged shares is demonstrated by comparing the existing facts with hypothetical situations in which such a loss may be found. Had Big Bear been required to pay for the shares used in the exchange, for instance, by purchasing shares from existing Big Bear shareholders, there would have been a clear loss of funds evidenced in the Big Bear financial statements. Big Bear's financial position prior to the exchange would have been significantly better than its position afterwards. However, no such difference results from the mere exchange of newly-issued shares. If there had been evidence that Big Bear was or could be compelled to redeem or retract the new shares at the value assigned to them at the time of the share exchange, Big Bear may have a loss in the amount of the exchange value of the shares. However, there is no evidence of such a redemption or retraction feature attaching to these shares.

[71] In sum, Big Bear's position prior to the share exchange is that the Big Bear shares issued as part of the exchange did not exist. As a result of the alleged misrepresentation, Big Bear issued shares from treasury. These shares would not have been issued but for the misrepresentation. All that is required to put Big Bear back into the position it was in prior to the negligent misrepresentation is compensation for the cost of issuing the shares, which is not the same as the exchange value of those shares. Although this is somewhat of an anomalous situation, it is consistent with the accepted tort principle that, except in cases warranting punitive damages, damages in tort are awarded to compensate for actual loss. A party may not recover in tort for a loss of something it never had. Indeed, if Big Bear was awarded damages for the share exchange equal to what it has claimed, it would be in a better position financially than it was prior to the exchange. To the extent that shareholders would indirectly benefit, they would not only be Big Bear's pre-exchange shareholders, who may have suffered a dilution loss, but a new group of shareholders, including former Blue Range shareholders who participated in the exchange.

[72] Big Bear submits that it incurred other losses as a result of the misrepresentation. Transaction costs incurred in the share exchange may be properly characterized as damages in tort, as those costs would not have been incurred but for the negligent misrepresentation. The same is true for the Big Bear claim for cash expended to purchase Blue Range shares prior to the share exchange. However, as I have indicated in my decision on Issue #1, Big Bear's claim for transaction costs and for cash share purchase damages ranks after the claims of other unsecured creditors. There may also be losses such as loss of ability to raise equity. There was no evidence of this before me in this application, and I have addressed Big Bear's ability to advance a claim for this type of loss in the decision relating to Issue #3.

[73] Finally, there may also be a loss in the form of dilution of the value of the Big Bear shares. However, as Big Bear admits in its submissions, no such claim is made by the corporation, and any loss relating to a diluted share value would not be the same amount as the exchange value of the shares.

[74] In the result, I find that Big Bear is not the proper party to pursue a claim for the alleged share exchange loss.

ISSUE #3

Is Big Bear entitled to make or advance by way of argument in these proceedings the claims represented by the heads of damage specified in the draft Statement of Claim set out at Exhibit "F" to the affidavit of A. Jeffrey Tonken dated June 25, 1999?

[75] In addition to claims for damages for negligent misrepresentation, the claims that are set out in the draft Statement of Claim are claims for remedies for oppressive and unfairly prejudicial conduct and claims for loss of opportunity to pursue valuable investments and endeavours and loss of ability to raise equity.

Summary of Decision

[76] Given the orders made by LoVecchio, J. on April 6, 1999 and May 11, 1999, Big Bear is not entitled to advance the claims represented by the heads of damage specified in the draft Statement of Claim other than as set out in its Notice of Claim.

Analysis

[77] Big Bear submits that it is clear that, in an appropriate case, a complex liability issue that arises in the context of CCAA proceedings may be determined by a trial, including provision for production and discovery: *Algoma Steel Corp. v. Royal Bank of Canada* [1992] O.J. No. 889 (Ont. C.A.). Big Bear also submits that the court has the jurisdiction to overlook technical complaints about the contents of a Notice of Claim. The CCAA does not prescribe a claim form, nor set the rules for completion and contexts of a claim form, and it is common ground that in this case, the form used for the "Notice of Claim" was not approved by any order of the court. At any rate, Big Bear submits that it is not seeking to amend its claim to add new claims or to claim additional amounts.

[78] It makes that assertion apparently on the basis that the major parties concerned with CCAA proceedings in the Blue Range matter were aware of the nature of Big Bear's additional claims by reason of the draft Statement of Claim attached to Mr. Tonken's May 5, 1999 affidavit, although that affidavit was filed in support of an application to lift the stay imposed under the CCAA, an application which was dismissed by LoVecchio, J. on May 11, 1999.

[79] Big Bear characterizes the issue as whether it must prove the exact amount claimed in its Notice of Claim or otherwise have its claim barred forever. It submits that the bare contents of the Notice of Claim cannot be construed as a fixed election barring a determination and assessment of an unliquidated claim for tort damages, and that it would be inequitable to deny Big Bear a hearing on the substance of its claim based on a perceived technical deficiency in the contents of the Notice of Claim.

[80] In summary, Big Bear asks that the court direct an expedited trial for the hearing of its

claim as outlined in the draft Statement of Claim.

[81] The Applicants submit that, by attempting now to make claims other than the claims set out in the Notice of Claim, Big Bear is attempting to indirectly and collaterally attack the orders of LoVecchio, J. dated April 6, 1999 and May 11, 1999, specifically:

a) by adding claims for alleged heads of damage other than those specified in the Notice of Claim contrary to the claims bar order of April 6, 1999; and

b) by attempting to include portions of the draft Statement of Claim relating to other alleged heads of damage in the Notice of Claim contrary to the May 11, 1999 order dismissing leave to file the draft Statement of Claim.

[82] While it is true that a court has jurisdiction to overlook technical irregularities in a Notice of Claim, the issue is not whether the court should overlook technical non-compliance with, or ambiguity in, a form, but whether it is appropriate to do so in this case where previous orders have been made relating to these issues. Here, Big Bear chose to pursue its claims through two different routes. It filed a Notice of Claim alleging damages for a share exchange loss, transaction costs and the cost of shares purchased before the takeover bid, all damage claims that can reasonably be identified as being related to an action for negligent misrepresentation. At about the same time, it brought an application to lift the stay granted under the CCAA and file a Statement of Claim that alleged other causes of action. That application was dismissed, and the order dismissing it was never appealed. This is not a situation as in *Re Cohen* (1956) 19 W.W.R. 14 (Alta. C.A.) where a claim made on one basis was later sought to be made on a different basis, nor an issue of Big Bear lacking the necessary information to make its claim, although quantification of damage may have been difficult to determine. Given the previous application by Big Bear, this is a collateral or indirect attack on the effectiveness of LoVecchio, J.'s orders, and should not be allowed: *Wilson v. The Queen* (1983) 4 D.L.R. (4th) at 599). The effect of the two orders made by LoVecchio, J. is to prevent Big Bear from advancing its claim other than as identified in its Notice of Claim, which cannot reasonably be interpreted to extend beyond the claims for damages for negligent misrepresentation.

[83] It is true that the Notice of Claim form is not designed for unliquidated tort claims. I do not accept, however, that it was not possible for Big Bear to include claims under other heads of damages in the claim process by, for example, attaching the draft Statement of Claim to the Notice of Claim, or by incorporating such claims by way of schedule or appendix, as was done with respect to the claims for damages for negligent misrepresentation.

[84] I note that LoVecchio, J. issued a judgment after this application was heard relating to claims for relief from the impact of the claims procedure established by the court by a number of creditors who filed late or wished to amend their claims after the claims bar date of May 7, 1999 had passed. Although LoVecchio, J. allowed these claims, and found that it was appropriate in the circumstances to grant flexibility with respect to the applications before him, he noted that total amount of the applications made to him would be less than 1.4 million dollars, and the impact of allowing the applications was minimal to the remaining creditors. The applications before him do not appear to involve issues which had been the subject of previous court orders, as in the current

situation, nor would they have the same implication to creditors as would Big Bear's claim. The decision of LoVecchio, J. in the circumstances of the applications before him is distinguishable from this issue.

DATED at Calgary, Alberta this 10th day of January, 2000.

J.C.Q.B.A.

TAB 5

Court of Queen's Bench of Alberta

Citation: EarthFirst Canada Inc. (Re) 2009 ABQB 316

Date: 20090527
Docket: 0801 13559
Registry: Calgary

Between:

In the Matter of the Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, as Amended

- and -

And In the Matter of a Plan of Compromise or Arrangement of Earthfirst Canada Inc.

Corrected judgment: A corrigendum was issued on July 8, 2009; the corrections have been made to the text and the corrigendum is appended to this judgment.

Reasons for Judgment of the Honourable Madam Justice B. E. Romaine

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INTRODUCTION

[1] Earthfirst Canada Inc. seeks a declaration as the proper characterization of potential claims of holders of its flow-through common shares for the purpose of a proposed plan of arrangement under the *Companies' Creditors Arrangement Act,* R.S.C. 1985, c. C-36, as amended. The issue is whether contingent claims that the flow-through subscribers may have are, at their core, equity obligations rather than debt or creditor obligations and, as such,

necessarily rank behind claims made by the creditors of Earthfirst. I decided that the potential claims are in substance equity obligations and these are my reasons.

FACTS

[2] The flow-through shares at issue were distributed in December, 2007 as part of an initial public offering of common shares and flow-through shares. The common shares plus one-half of a warrant were offered at a price of $2.25 per unit. The flow-through shares were offered at a price of $2.60 per share. Investors who wished to purchase flow-through shares were required to execute a subscription agreement which included the following covenants of Earthfirst:

> 6.(b) to incur, during the Expenditure Period, Qualifying Expenditures in such amount as enables the Corporation to renounce to each Subscriber, Qualifying Expenditures in an amount equal to the Commitment Amount of such Subscriber;
>
> (c) to renounce to each Subscriber, pursuant to subsection 66(12.6) and 66(12.66) of the Tax Act and this Subscription Agreement, effective on or before December 31, 2007, Qualifying Expenditures incurred during the Expenditure Period in an amount equal to the Commitment Amount of such Subscriber;
>
> . . .
>
> (g) if the Corporation does not renounce to the Subscriber, Qualifying Expenditures equal to the Commitment Amount of such Subscriber effective on or before December 31, 2007 and as the sole recourse to the Subscriber for such failure, the Corporation shall indemnify the Subscriber as to, and pay to the Subscriber, an amount equal to the amount of any tax payable under the Tax Act (and under any corresponding provincial legislation) by the Subscriber (or if the Subscriber is a partnership, by the partners thereof) as a consequence of such failure, such payment to be made on a timely basis once the amount is definitively determined, provided that for certainty the limitation of the Corporation's obligation to indemnify the Subscriber pursuant to this Section shall not apply to limit the Corporation's liability in the event of a breach by the Corporation of any other covenant, representation or warranty pursuant to this Agreement or the Underwriting Agreement;

[3] Certain conditions were required to be satisfied before expenditures made by Earthfirst would qualify as "Qualifying Expenditures" pursuant to the *Income Tax Act* and the associated regulations. Because construction of Earthfirst's Dokie 1 wind power project was interrupted by events triggered by the CCAA filing, it may be that Earthfirst will not be able to satisfy some of these conditions. While Earthfirst is seeking a purchaser of the Dokie 1 project assets, and that purchaser may complete the necessary requirements for expenditures to be considered "Qualifying Expenditures", there is presently no guarantee that the necessary conditions will be

met. The subscribers for flow-through shares may therefore have a claim under the indemnity set out in the subscription agreement.

ISSUE

Are the claims under the indemnity debt claims or claims for the return of an equity investment?

ANALYSIS

The flow-through share subscribers submit that their indemnity claims are not claims for the return of capital. Counsel for the flow-through share subscribers makes some persuasive arguments in that regard, including:

(a) that the underlying rights that form the basis of the claims are severable and distinct from the status of subscribers as shareholders of Earthfirst, in that the flow-through shares are composed of two distinct components, being common shares and the subscriber's right to the renunciation of a certain amount of tax credit or the right to be indemnified for tax credit not so renounced. It is submitted that further evidence of the distinct and severable nature of the indemnity claim can be found in the fact that, while the common share component of the flow-through shares can be transferred, the flow-through benefits accrue only to original subscribers;

(b) that the claimants in advancing a claim under the indemnity are not advancing a claim for the return of their investment in common shares;

(c) that the rights and obligations that form the basis of the indemnity claim are set out in the subscription agreement, which indicates an intention to create a debt obligation in the indemnity provisions; and

(d) that the claim under the indemnity is limited to a specific amount as compared to the unlimited upside potential of any equity investment, and that thus one of the policy reasons for drawing a distinction between debt and equity in the context of insolvency does not apply to an indemnity claim.

[4] On the other side of the argument, it is clear that the indemnity claim derives from the original status of the subscribers as subscribers of shares, that the claim was acquired as part of an investment in shares, and that any recovery on the indemnity would serve to recoup a portion of what the subscriber originally invested, primarily qua shareholder. While it may be true that equity may become debt, as, for instance, in the case of declared dividends or a claim reduced to a judgment debt (Re I. Waxman & Sons Ltd. [2008] O.J. No. 885 at para 24 and 25), the indemnity claim has not undergone a transformation from its original purpose as a "sweetener" to the offering of common shares, even if individual subscribers have since sold the shares to which it was attached. The renunciation of flow-through tax credits, despite the payment of a premium for this feature, can be characterized as incidental or secondary to the equity features of the investment, a marketing feature that provided an alternative to the share plus warrant tranche

of the public offering for investors who found the feature attractive: *Canada Deposit Insurance Corp. v. Canadian Commercial Bank* [1992] S.C.J. No. 96 at para. 54.

[5] This type of indemnity skirts close to the line that courts are attempting to draw with respect to the characterization and ranking of equity and equity-type investments in the insolvency context. In Alberta, that line is drawn by the decision of LoVecchio, J. in *National Bank of Canada v. Merit Energy Ltd.*, 2001 A.J. No. 918, upheld by the Court of Appeal at [2002] A.J. No. 6. The indemnity at issue in Merit Energy was substantially identical to the one at issue in this case. While Lovecchio, J. appeared to refer to elements of misrepresentation arising from prospectus disclosure with respect to the Merit indemnity claim at para. 29 of the decision, it is clear that he considered the debt features of the indemnity in his later analysis, and noted at para. 54 that:

> While the Flow-Through Shareholders paid a premium for the shares (albeit to get the deductions), in my view the debt features associated with the CEE indemnity from Merit do not "transform' that part of the relationship from a shareholder relationship into a debt relationship. That part of the relationship remains "incidental" to being a shareholder.

The Court of Appeal in dismissing the appeal commented:

> Counsel for the appellant stresses the express indemnity covenant here, but in our view, it is ancillary to the underlying right, as found by the chambers judge. Characterization flows from the underlying right, not from the mechanism for its enforcement, nor from its non-performance.

The decision in Merit Energy thus determines the issue in this case, which is not distinguishable on any basis that is relevant to the issue. I also note that, while it is not determinative of the issue as the legislation has not yet been proclaimed, section 49 of Bill C-12, *An Act to amend the Bankruptcy and Insolvency Act,* the *Companies' Creditors Act*, the *Wage Protection Program Act* and Chapter 47 of the *Statues of Canada*, 2005, 2nd Sess., 39th Parl., 2007, ss. 49, 71 [Statute c.36] provides that a creditor is not entitled to a dividend in respect of any equity claim until all other claims are satisfied. Equity Claims are defined as including:

(a) a dividend or similar payment,
(b) a return of capital,
(c) a redemption or retraction obligation,
(d) a monetary loss resulting from the ownership, purchase or sale of an equity interest or from the rescission, or, in Quebec, the annulment, of a purchase or sale of an equity interest, or
(e) contribution or indemnity in respect of a claim referred to in any paragraphs (a) to (d) [emphasis added].

CONCLUSION

I therefore grant:

a) a declaration that potential claims that holders of flow-through common shares in Earthfirst may have against Earthfirst, if any, are at their core equity obligations rather than debt or creditor obligations, and, as such, necessarily rank behind in priority to claims made by creditors of Earthfirst and will not participate in any creditor plan or distribution; and

b) an order permitting Earthfirst to make certain payment to its creditors pursuant to a Plan of Arrangement in an amount and upon such terms to be determined by this Honourable Court at the date of this application without regard to any contingent or other claims of the flow-through shareholders or subscribers.

Heard on the 13th day of May, 2009.

Dated at the City of Calgary, Alberta this 27th day of May, 2009.

B.E. Romaine

J.C.Q.B.A.

Appearances:

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Howard A. Gorman
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Corrigendum of the Reasons for Judgment

of

The Honourable Madam Justice B. E. Romaine

The citation "Earthfirst Canada Inc. *(Companies' Creditors Arrangement Act)* 2009 ABQB 316" was corrected to read "Earthfirst Canada Inc. (Re) 2009 ABQB 316"

TAB 6

CANADIAN BANKRUPTCY AND INSOLVENCY LAW

BILL C-55, STATUTE C.47 AND BEYOND

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be observed by the OSB when seeking to exercise its new supervisory powers regarding receivers as licensed trustees in bankruptcy.

Bill C-62 makes further changes. It provides for a new BIA, section 243, which will allow the courts to confer a wide range of powers on the receiver, including: (a) the exercise of any control the court considers advisable over the insolvent person's or bankrupt's property or business; and (b) the taking of any other action the court considers advisable.

V. COURT-APPOINTED OFFICERS: INTERIM RECEIVERS

Statute c.47 appears to confine interim receivers to a truly interim role by providing for appointments to expire automatically: (a) on the happening of specified events; (b) after 60 days following the appointment; or (c) at the end of such other period as may be specified by the appointing court.[48] These amendments are consistent with a Senate Report recommendation that the BIA be amended to clarify the role of the interim receiver, and the duration and meaning of the term "interim".[49] However, BIA sections 47 and 47.1 currently authorize the courts to confer broad remedial powers on an interim receiver of indeterminate length, and these provisions have been omitted from Statute c.47.[50]

Occasionally, the role of the monitor in a CCAA case has been expanded by the appointment of the monitor as interim receiver of the debtor for the duration of the proceedings with carriage of the proposed restructuring plan. This technique may be helpful in cases where removing or replacing one or more of the debtor's directors may not represent the most effective means of ensuring that the debtor is able to propose a viable restructuring plan. It would be regrettable if Statute c.47 were to deny the possibility of an interim receivership appointment in such cases.[51]

VI. EQUITY INTEREST PROVISIONS

Statute c.47 does not adequately address issues relating to equity interests in an insolvency context. In particular, the statute does not (a) apply to all forms of equity interests;[52] (b) expressly permit the court supervising a reorganization to

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48 Statute c.47, *supra* note 1, ss. 30-31; ss. 47 and 47.1, amended BIA.

49 Senate Report, *supra* note 5 at xxii, Recommendation 33.

50 Contrary to the recommendation of the JTF Report, *supra* note 3, Schedule A at 6. Recommendation 38, and with all of the shortcomings such an omission brings, as discussed in the LRTF Report, *supra* note 2, Schedule B at 17-20 and 47-53.

51 *Ibid.*

52 As was called for in the JTF Report, *supra* note 3, Schedule A at 9, Recommendation 62.

dispense with the need for "equity" approvals;[53] or (c) uniformly treat equity interests in BIA and CCAA reorganization cases and expressly provide for their subordination and non-voting status.[54]

Given these shortcomings, we anticipate continuing influence by equity interests in the carriage and outcome of Canadian insolvency proceedings disproportionate to the economic interest they represent. For example, because it is not presently clear that all corporate reorganizations involving share capital can be effected in combination with an insolvency proceeding, this prospect could give rise to a veto by equity holders. Similarly, the necessity for shareholder approvals for certain types of disposition transactions or the ability of shareholders to vote to appoint or replace directors during the administrative period could lead to governance "log-jams". Insofar as corporate statutes may be read as requiring such approvals or doubt exists as to whether the court may dispense with such approvals, equity interests may continue to influence the outcome of a restructuring attempt.

Similarly, the voting of shareholder "damage claims" as creditor interests could also have a disproportionate impact on Canadian corporations seeking to restructure. The Senate Report recommended that the BIA be amended to provide for the subordination of claims derived from equity concerns, such as the claim of a seller or purchaser of equity securities for damages or rescission.[55] Amended BIA section 140.1 implements the recommendation,[56] which will apply in bankruptcy proceedings. It will also apply in BIA proposal proceedings by virtue of section 66(1) of the BIA. Amended BIA section 54(2)(a)(i) supplements amended section 140.1 and provides, in effect, that a creditor whose claim is subordinated pursuant to section 140.1 may not vote on the proposal. Without the provision, subordinated creditors might end up with a power of veto over the proposal, particularly if they are placed in a separate class from the other unsecured creditors. The consequence would be to enhance their entitlements rather than subordinate them.[57] The same concern arises in relation to voluntary (or contractual subordinations). If a subordinated creditor is placed in a separate class for voting purposes and allowed to vote, this creditor may end up with a power of veto over the proposal which would be inconsistent with its subordinated status. Unless proposed section 54(2)(a)(i) is amended so that it applies to all subordinated claims, however arising, courts will continue to be required to address the classification of subordinate claims in connection with BIA proposals.

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53 As was called for in the JTF Report, *ibid.*, Recommendations 61 and 62 and the Supplemental JTF Report, *supra* note 4, Schedule S at 5, Recommendation S12.

54 As noted in the LRTF Report, *supra* note 2 at 14-15.

55 Senate Report, *supra* note 5 at xxiv, Recommendation 40.

56 The amendment in effect codifies the decision in *Re Blue Range Resource Corp.*, [2002] A.J. No. 14, [2000] 4 W.W.R. 738 (Alta. Q.B).

57 This is in effect what happened in *Menegon v. Philips Services Corp.*, [1999] O.J. No. 4080, 11 C.B.R. (4th) 262 (Ont. Sup. Ct. J.) and the proposed amendments are not sufficient to reverse the effect of that decision.

Amended CCAA section 22(3) is similar to BIA section 4(2)(a)(i), but there is no counterpart in the CCAA to BIA section 140.1. There are two issues at stake: (1) whether equity claims should be subordinated to general unsecured creditors' claims, and (2) whether equity claim holders should be disqualified from voting. An affirmative answer to issue (2) depends on an affirmative answer to issue (1). Unlike the corresponding BIA provisions, the proposed new CCAA provisions only address issue (1).

Furthermore, aside from damages or rescission claims, Statute c.47 makes no provision for plans to bind members of an equity class without their approval or without the need for consideration to be provided to the members of the equity class. Nor does it provide that equity claims may be extinguished. The net result is that equity claims may have an entitlement to participate *pro rata* in distributions with unsecured creditors generally in CCAA cases and an incentive to participate in the restructuring at all stages disproportionate to their typical economic interest as equity holders.

Bill C-62 makes the following further changes and addresses many, but not all, of the shortcomings identified above:

- new definitions for "equity claims", "equity interests", and "shareholders" have been provided to broaden the nature of the equity interests and claims expressly subject to the BIA and the CCAA;
- new BIA, section 54.1, and new CCAA, section 22.1, both provide that equity claims are to be included in the same class and may not vote in respect of a proposal or plan unless the supervising court otherwise orders;
- new BIA, section 59(4), and new CCAA, section 6(2), provide that supervising courts may grant orders effecting changes to a debtor's constating documents in accordance with a sanctioned proposal or plan without the need for any shareholder or equity approval to effect any changes to those constating documents that might otherwise be lawfully made;
- new BIA, section 140.1, provides that a creditor is not entitled to a dividend under a proposal in respect of an equity claim until all other claims have been satisfied;
- new BIA, section 39(2)(1.7), and new CCAA, section 6(8), provide that no proposal or plan providing for the payment of an equity claim may be approved or sanctioned by the court unless the proposal or plan also provides that all other claims are to be paid in full before the equity claim is to be paid;
- new BIA, section 54(2)(d), dispenses with the need for any equity claim vote to approve a proposal as unsecured creditors, unless the court orders otherwise;
- new BIA, section 66(1.4), provides that the proposal provisions may be used in conjunction with any federal or provincial Act that authorizes or provides for compromises or arrangements between a corporation and its shareholders; and

- new BIA, section 65.13(1), and new CCAA, section 36(1), each provide for the ability of a court to authorize a sale or other disposition of assets out of the ordinary course of business despite any requirement for shareholder approval, whether under federal or provincial law.

VII. PRIORITY OF CHARGES IN BIA AND CCAA PROCEEDINGS[58]

Statute c.47 would codify a number of super-priority charges, some having statutory priority in bankruptcy and others depending on court order during a reorganization, against the current and fixed assets of a debtor.[59] All such charges can rank in priority to the claims of existing secured lenders. The newly created charges relate to employee wage and expense claims;[60] certain unremitted pension plan contributions;[61] so-called "DIP loans";[62] administrative expenses;[63] and director and officer liabilities.[64] These charges are in addition to existing rights in respect of deemed trusts for employee source deductions[65] and the rights of suppliers.[66]

Statute c.47 supplements these liquidation priorities by providing that no proposal or plan of arrangement shall be approved by the court unless it provides for the payment of unremitted employee source deductions, employees' preferred (now secured) claims, and the pension plan amounts outlined in sections 81.5 and 81.6.[67] The statute contains provisions to waive this last requirement if an agreement otherwise is reached and approved by the relevant pension regulator.

Statute c.47 ranks the relative priorities of the following items in descending order: (a) existing supplier rights; (b) statutory deemed trusts relating to source deductions; (c) the newly created super-priority charges for employee related claims; and (d) existing secured claims.[68] However, the amended legislation neither specifies the relative priorities of court-ordered charges that may be granted in respect of DIP loans, administrative expenses, and director and officer liabilities,

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58 See further Chapter 5, above.

59 As noted in the LRTF Report, *supra* note 2 at 15-16.

60 Statute c.47, *supra* note 1, s. 67; ss. 81.3 and 81.4, amended BIA.

61 Statute c.47, *ibid.*; ss. 81.5, 81.6, amended BIA.

62 Statute c.47, *ibid.*, s. 36 and s. 128; s. 50.6(1), amended BIA, and s. 11.2, amended CCAA, respectively.

63 Statute c.47, *ibid.*, s. 42 and s. 128; s. 64.2, amended BIA, and s. 11.52, amended CCAA, respectively.

64 Statute c.47, *ibid.*; s. 64.1, amended BIA, and s. 11.51, amended CCAA.

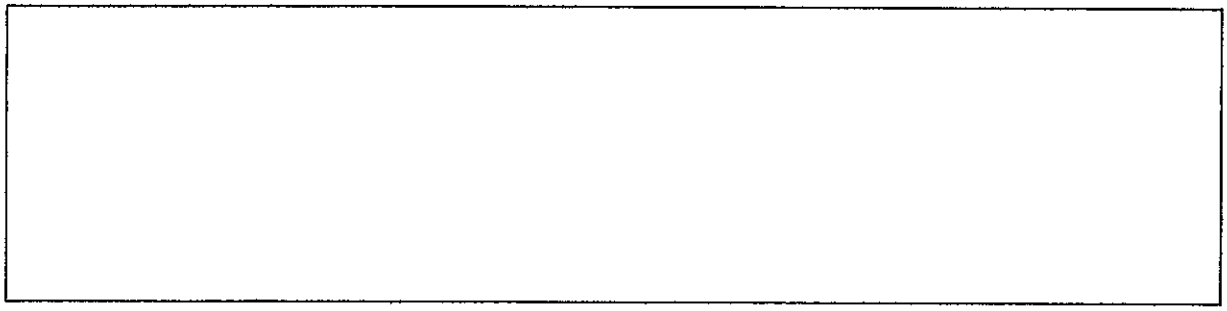
65 BIA, *supra* note 6, s. 67(3).

66 *Ibid.*, ss. 81.1 and 81.2.

67 Statute c.47, *supra* note 1, s. 39 and s. 126; s. 60(1.4), amended BIA, and s. 6, amended CCAA, respectively.

68 Statute c.47, *ibid.*, s. 67; ss. 81.1-81.6, amended BIA.

TAB 7



• EQUITY CLAIMS AND THE REFORM OF INSOLVENCY LEGISLATION •

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A 2009 decision of the Alberta Court of Queen's Bench in *EarthFirst Canada Inc.*[1] has brought attention again to the issue of the characterizations and rankings of equity and equity-type claims in the insolvency context. In *EarthFirst*, Madam Justice Romaine considered the status of claims of the holders of flow-through common shares in the insolvency context, in particular claims of the shareholders arising from rights to indemnification given by the company. Justice Romaine concluded that the characterization

of the claims was difficult, but that the claims were, at their core, equity claims and therefore subordinate to the claims of the company's creditors. In reaching her conclusion she considered (but could not apply) amendments to the *Companies' Creditors Arrangement Act* [*CCAA*] that were about to come into force. These amendments were intended to provide clarity and greater certainty: clarifying that equity claims are subordinate to debt claims and providing guidance to assist courts in characterizing claims as equity or debt.[2] As the relevant amendments are now in force, the *EarthFirst* decision provides an appropriate context for reviewing the origin and purpose of this aspect of insolvency law reform.

THE *EARTHFIRST* DECISION AND THE TREATMENT OF EQUITY CLAIMS

EarthFirst was a developer of renewable wind energy. EarthFirst's capital structure included flow-though common shares. Flow-through common shares are securities that are issued to help finance project development activities. The securities have the features of common shares, but are supplemented by a flow-through feature that allows the issuer to transfer (or "renounce") expenses related to project development activities to the holders of the securities. These expenses can then be applied against the earnings of the holder to reduce taxable income. If project development expenses are not renounced, the shareholder may lose part of the value of the original investment.

When EarthFirst issued its flow-through common shares, it agreed with the shareholders to incur and renounce certain project development expenses or, alternatively, to indemnify the shareholders in respect of the tax consequences of failing to do so:

> Pursuant to the Subscription Agreement, the Corporation will covenant and agree: (i) to incur on or before December 31, 2008, and renounce to the Flow-Through Subscriber effective on or before December 31, 2007, CEE in an amount equal to the aggregate purchase price paid by such Flow-Through Subscriber, and (ii) that if the Corporation does not renounce to such Flow-Through Subscriber, effective on or before December 31, 2007, CEE equal to such amount, or if there is a reduction in such amount renounced pursuant to the provisions of the Tax Act, the Corporation shall indemnify the Flow-Through Subscriber as to, and forthwith pay in settlement thereof to such Flow-Through Subscriber, an amount equal to the amount of any tax payable or that may become payable under the Tax Act (and under any corresponding provincial legislation) by the Flow-Through Subscriber as a consequence of such failure or reduction. [Emphasis added.][3]

On November 4, 2008, EarthFirst commenced proceedings under the *CCAA*. As part of the *CCAA* proceedings, EarthFirst sought a purchaser for its Dokie I wind power project, whose development was a condition of allowing the company to meet its obligation to renounce project development expenses. Because the sale and continued development of the Dokie I project was uncertain, it was possible that EarthFirst would be unable to meet its obligation to renounce project development expenses. This would give rise to claims in respect of the rights to indemnification promised by EarthFirst. EarthFirst therefore sought a declaration from the Court as to the status of the rights to indemnification that the holders of the flow-through common shares could have.[4]

Justice Romaine had to consider whether the rights to indemnification that the holders of the flow-through common shares could have were debt claims or equity claims. She found that those claims were at their core equity claims. She noted that equity claims may have some features of a debt, and that in some instances equity may be transformed and become debt, making the characterization of the claims difficult. In respect of the flow-though shares of EarthFirst, the rights to indemnification were merely "sweeteners" associated with the sale of those securities. She also noted that the claims derived from the status of the claimants as subscribers for the flow-through common shares, and that the purpose of the claims was to recoup a portion of what had originally been invested by the holders of the flow-through shares — in essence, a claim for the return of the equity investment. Justice Romaine held that the renunciation of project development expenses was merely an incidental aspect of the flow-through shares, secondary to the common share features of the securities.[5] She noted the difficulty in this case of characterizing the claims, acknowledging that "this type of indemnity skirts close to the line that courts are attempting to draw with respect to the characterization and ranking of equity and equity-type investments in the insolvency context."[6]

In concluding that the claims of the holders of EarthFirst's flow-through common shares must rank behind the claims of creditors, Romaine J. noted that the position of the shareholders was analogous to the position of similarly situated shareholders in *National Bank of Canada v. Merit Energy Inc.*,[7] making the difficult line-drawing exercise easier for the court in *EarthFirst*. In *Merit Energy*, Mr. Justice LoVecchio had also considered claims for indemnification made by the holders of flow-through common shares, and he held that they were also equity claims:

> The second claim of the Flow-Through Shareholders has some of the features of a debt and the Subscription and Renunciation Agreements provide for a specific remedy in the event Merit fails to comply with its undertaking to make and renounce the CEE expenditures.
>
> ... The tax advantages associated with flow-through shares is reflected in a premium paid for the purchase of the shares. In essence, what happens in a flow-through share offering (as sanctioned by the Income Tax Act) is the shareholder buys deductions from the company. As the company has given up deductions, it wants to be paid for those deductions that it is renouncing. From the perspective of the purchaser of the shares, the premium for the shares would not have been paid without some assurance that the deductions will be available. I note the purchaser is also required to reduce their adjusted cost base of the shares (for tax purposes) by the amount of the deductions utilized by the purchaser.
>
> While the Flow-Through Shareholders paid a premium for the shares (albeit to get the deductions), in my view the debt features associated with the CEE indemnity from Merit do not "transform" that part of the relationship from a shareholder relationship into a debt relationship. That part of the relationship remains "incidental" to being a shareholder.
>
> In summary, the Flow-Through Shareholders' claims, regardless of the basis chosen to support them, are in substance claims for the return of their equity investment and accordingly cannot rank with Merit's unsecured creditors.[8]

In addition to relying on this reasoning from *Merit Energy*, Romaine J. considered amendments to the *CCAA* that had been passed by Parliament but not proclaimed into force at the time the *EarthFirst* decision was made. Those amendments to the *CCAA* (as discussed below) explicitly address the status of equity claims in insolvency proceedings. Among other things, the amendments prohibit the payment of dividends in respect of equity claims until all other claims are satisfied, and they define equity claims very broadly to capture all claims relating to equity interests, including, therefore, claims relating to the flow-through common shares.

While Romaine J. could not apply these amendments to the claims of the holders of EarthFirst's flow-though common shares, the reference to them suggests that, had the amendments been in force, they would have been determinative of the issue. The amendments, if they could have been applied, would therefore have made the line-drawing exercise for equity claims much easier because the claims at issue were captured by the amended *CCAA*. The amendments to the *CCAA*, and the related amendments to the *BIA*, were intended to have this effect to make it easier to deal with equity claims in insolvency proceedings, and to bring certainty to this area of the common law.

THE STATUS OF THE COMMON LAW REGARDING EQUITY CLAIMS

In *Merit Energy*, LoVecchio J. had reviewed the status of the common law as it relates to characterizing equity claims in the insolvency context. The position of equity claims relative to debt claims is clear: they rank behind claims of creditors in insolvency, but characterizing a claim as equity or debt is often a difficult interpretative exercise, as Romaine J. acknowledged in *EarthFirst*.[9]

The Supreme Court of Canada addressed the characterization issue in *Canada Deposit Insurance Corp. v. Canadian Commercial Bank*.[10] In that case, the Supreme Court had to determine whether an agreement to participate in a portion of a bank's loan portfolio was an equity investment or a loan. The Supreme Court noted that the characterization exercise was a matter of interpreting the agreements in question to see what the parties reasonably intended, and that the exercise could be a difficult one. Writing for the Court, Mr. Justice Iacobucci stated that "the characterization issue facing this Court must be decided by determining the intention of the parties to the supporting agreements. This task, perplexing as it sometimes proves to be, depends primarily on the meaning of the words chosen by the parties to reflect their intention."[11] In *CDIC*, the agreements included characteristics associated with both debt and equity financings, but in substance the agreement was a loan agreement. Reaching this conclusion was not a straightforward matter, as reflected in the Court's reasoning:

> Instead of trying to pigeonhole the entire agreement between the Participants and CCB in one of two categories, I see nothing wrong in recognizing the arrangement for what it is, namely, one of a hybrid nature, combining elements of both debt and equity but which, in stance, reflects a debtor-creditor relationship. Financial and capital markets have been most creative in the variety of investments and securities that have been fashioned to meet the needs and interests of those who participate in those markets. It is not because an agreement has certain equity features that a court must either ignore these features as if they did not exist or characterize the transaction on the whole as an investment. There is an alternative. It is permissible, and often required, or desirable, for debt and equity to co-exist in a given financial transaction without altering the substance of the agreement. Furthermore, it does not follow that each and every aspect of such an

> agreement must be given the exact same weight when addressing a characterization issue. Again, it is not because there are equity features that it is necessarily an investment in capital. This is particularly true when, as here, the equity features are nothing more than supplementary to and not definitive of the essence of the transaction. When a court is searching for the substance of a particular transaction, it should not too easily be distracted by aspects which are, in reality, only incidental or secondary in nature to the main thrust of the agreement.[12]
> [Emphasis in the original]

In *Re Central Capital Corporation*,[13] the Court of Appeal for Ontario had to characterize a claim arising from the right of retraction in respect of certain preference shares: did the holders of those preference shares have a provable claim under the *BIA* in respect of the right to require the company to redeem the preference shares? Although the relationship of the holders of the preference shares had characteristics of both debt and equity, the Court of Appeal held that, in substance, the holders of the preference shares had equity claims with respect to their right of retraction, which provides for the return of capital, not for the repayment of a loan.

As Romaine J. noted in *EarthFirst*, an equity claim may also be transformed into a debt claim, and whether or when this happens is a matter of characterization. Some of the claims of issue in *Merit Energy*, and claims at issue in an earlier decision of Romaine J. in *Blue Range Resource Corporation*,[14] were claims by shareholders for damages based on misrepresentations made when their shares were acquired. The courts in both cases held that the fact that the shareholders may have claims in tort does not transform those claims into debt claims — the claims remained equity claims because they were derived from the claimants' status as shareholders and in connection with the equity investment. In *Blue Range*, Romaine J. held that the claim of the shareholder (Big Bear) was in substance an equity claim:

> It is true that Big Bear does not claim recission. Therefore, this is not a claim for return of capital in the direct sense. What is being claimed, however, is an award of damages measured as the difference between the "true" value of Blue Range shares and their "misrepresented" value — in other words, money back from what Big Bear "paid" by way of consideration ... A tort award to Big Bear could only represent a return of what Big Bear invested in equity of Blue Range. It is that kind of return that is limited by the basic common law principle that shareholders rank after creditors in respect of any return on their equity investment.[15]

This analysis and the conclusion accord with the policy rationale that underlies the ranking of equity and debt claims in the insolvency context, identified by Romaine J. in *Blue Range*: even defrauded shareholder claimants are presumed to have bargained for equity-type profits, and assumed equity-type risks, whereas creditors are presumed to have dealt with the company on the basis that their claims were in priority to such shareholder claims.

While in *Merit Energy* and *Blue Range* the shareholders' claims were characterized as equity claims, the Court came to a different conclusion in *Re I. Waxman & Sons Limited*.[16] In that case, the claimant had obtained a judgment in an oppression action in his capacity as a shareholder. However, the Court concluded that this claim, which began in equity, was properly characterized as a debt claim: "By virtue of the judgment, the money award becomes debt and is properly the subject of a proof of claim in bankruptcy. In this regard, the facts in this case are unlike those in [*Blue Range*] or [*Merit Energy*]. Those cases involved causes of action that had been asserted in court proceedings but in neither case had judgment been rendered."[17]

More recently, an inter-company claim in *Smurfit-Stone Container Canada Inc.* had to be characterized as part of a *CCAA* proceeding.[18] A loan had been advanced between affiliates, the terms of which required that, on an insolvency, the loan would be repayable in shares of the borrower. The borrower argued that the parties intended the investment to be an equity investment in the event of an insolvency, and therefore the claim should be characterized as an equity claim. The Court rejected this argument, finding that the intention of the parties, as revealed by the agreement between them, was that the investment was a loan, albeit one repayable in equity in certain circumstances.[19]

REFORM OF INSOLVENCY LAW

As the cases discussed above indicate, the characterization of claims as debt claims or equity claims can be difficult, resulting in uncertainty. This led to the reform of insolvency law and the amendments to the *CCAA* that Romaine J. referred to in *EarthFirst*, and to parallel amendments to the *BIA*.

The need for reform, and the suggested scope of the reform, was addressed in 2002 by the Insolvency Institute of Canada and the Canadian Association of Insolvency and Restructuring Professionals in the *Report of the Joint Task Force on Business Insolvency Reform*.[20] The Joint Task Force recommended that insolvency legislation be amended to address the circumstances that arise in the cases discussed above, and to provide that "all claims against a debtor in an

insolvency proceeding that arise under or relate to an instrument that is in the form of equity, including claims for payment of dividends, redemption or retraction or repurchase of shares and damages (including securities fraud claims) are to be treated as equity claims subordinate to all other secured and unsecured claims against the debtor."[21] The list of specific claims in the proposal captures the kinds of claims that were at issue in *Central Capital*, *Merit Energy*, *Blue Range* and *EarthFirst*. The principled rationale for the proposed reform was consistent with the principles identified by Romaine J. in *Blue Range* and applied by the Court in that case: equity investors bargain for claims of lower priority than debt claims. Clarifying this in amendments to the *CCAA* and *BIA* would provide greater certainty.

The Standing Senate Committee on Banking, Trade and Commerce came to the same conclusion in a 2003 report. The Committee recommended that insolvency legislation should be amended to clarify the subordination of equity claims: "their claims should be afforded lower ranking than secured and unsecured creditors, and the law — in the interests of fairness and predictability — should reflect both this lower priority for holders of equity and the notion that they will not participate in a restructuring or recover anything until all other creditors have been paid in full."[22]

The recommended reform to insolvency law was ultimately passed into law as amendments to the *CCAA* and *BIA*. The amendments addressing the status of equity claims were presented in Bill C-12 in 2007, and came into force on September 18, 2009.[23]

The amendments to the *CCAA* and *BIA* effected through Bill C-12 clearly subordinate equity claims. The amendments exclude the entire class of creditors having "equity claims" from the right to vote on a plan or proposal unless the court orders otherwise, and they prohibit the court from approving a plan or proposal that provides for the payment of an equity claim, unless all other claims are to be paid in full before the equity claims are paid.[24] The amendments, in addition, provide that equity claims based on misrepresentations (*i.e.*, the claims in *Merit Energy* and *Blue Range*) may be compromised in a plan or proposal, and will be discharged in a bankruptcy.[25]

The amendments define "equity claim" very broadly to include any claim relating to an "equity interest," defined as a share in a corporation, including a warrant, option or other right to acquire a share, or in the case of an income trust an income trust unit or an option, warrant or other right to acquire a unit in the income trust. An "equity claim" is defined in the amendments as follows:

> a claim that is in respect of an equity interest, including a claim for, among others,
>
> (a) a dividend or similar payment,
>
> (b) a return of capital,
>
> (c) a redemption or retraction obligation,
>
> (d) a monetary loss resulting from the ownership, purchase or sale of an equity interest or from the rescission, or, in Quebec, the annulment, of a purchase or sale of an equity interest, or
>
> (e) contribution or indemnity in respect of a claim referred to in any of paragraphs (a) to (d)[26]

The stated purpose of the amendments is consistent with the recommendations and proposals that preceded them. Industry Canada's clause-by-clause analysis of the amendments notes, in reference to the provision in the *CCAA* restricting the voting rights of creditors with equity claims, that "[t]he amendment is one of several made with the intention of classifying that equity claims are to be subordinate to other claims. Equity claims are ownership interests, and as such, should be subject to the risks of insolvency."[27] In order to achieve that intended purpose, the amendments have defined equity claims as broadly as possible to include any claim that relates to an equity interest, including but not limited to the kinds of claims dealt with in cases such as *Central Capital*, *Merit Energy*, and *Blue Range*.

CONCLUSION

In referring to the amendments to the *CCAA* in *EarthFirst*, Romaine J. suggests that, had she been able to apply them, the characterization exercise in respect of the claims of the holders of flow-through common shares would have been less difficult because the claims would have fallen squarely within the broad definition of equity claims included in the amendments to the *CCAA*, and therefore would have clearly been subordinate to equity claims in the ways specified by the *CCAA*. It remains to be seen whether the amendments to the *CCAA* and *BIA* will make the characterization of claims as equity or debt less difficult, thereby bringing clarity and certainty to this area of insolvency law.

[*Editor's note*: Andrew Gray is a partner at the Toronto office of Torys LLP. Mr. Gray's practice focuses on civil litigation in a variety of areas, including corporate/commercial, securities and insolvency matters.

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1 [2009] A.J. No. 749, 2009 ABQB 316 (Q.B.) [*EarthFirst*].

2 The amendments to the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36 [*CCAA*] and the

Bankruptcy and Insolvency Act, R.S.C 1985, c. B-3 [*BIA*], and the background to the amendments, are described below in the third section of the article.

3 This description of the obligation is quoted from the prospectus of EarthFirst, dated November 27, 2007 and accessed through <www.sedar.com>.

4 EarthFirst ultimately entered into an agreement to sell the Dokie I project, and the asset purchase agreement included a covenant by the purchaser to make reasonable commercial efforts to complete the steps necessary to allow project development expenses to be renounced to the holders of the flow-though common shares. EarthFirst exited the *CCAA* proceedings by amalgamating with Maxim Power Corp. in March 2010.

5 *EarthFirst, supra* note 1 at para. 4.

6 *Ibid.*

7 *National Bank of Canada v. Merit Energy Ltd.*, [2001] A.J. No. 918, 2001 ABQB 583 (Q.B.) [*Merit Energy*].

8 *Ibid.* at paras. 52-55.

9 *Ibid.* at paras. 23 to 30.

10 [1992] S.C.J. No. 96, [1992] 3 SCR 558 [*CDIC*].

11 *CDIC, supra* note 10 at para. 51.

12 *CDIC, supra* note 10, at para. 54.

13 [1996] O.J. No. 359, 27 O.R. (3d) 494 (C.A.) [*Central Capital*].

14 [2000] A.J. No. 14, 15 CBR (4th) 169 (Alta. Q.B.) [*Blue Range*].

15 *Ibid* at para. 23.

16 [2008] O.J. No. 885 (S.C.J.) [*Waxman*].

17 *Ibid* at para. 25.

18 Unreported decision of the Honourable Madam Justice Pepall, Ontario Superior Court of Justice, January 28, 2010, accessed online at <http://www.deloitte.com/view/en_CA/ca/specialsections/insolvencyandrestructuringproceedings/smurfit-stonecontainercanada/index.htm> [*Smurfit Stone*].

19 The court in *Smurfit Stone* went on to find that, although the claim was a debt claim, it was not a claim provable in bankruptcy within the meaning of s. 121 of the *BIA*, and was therefore not a claim for the purposes of s. 12(1) of the *CCAA*.

20 Insolvency Institute of Canada and the Canadian Association of Insolvency and Restructuring Professionals, *Report of the Joint Task Force on Business Insolvency Reform*, March 2002. Some of the background that preceded the amendments is discussed in an excellent article by J. Sarra, "From Subordination to Parity: An International Comparison of Equity Securities Law Claims in Insolvency Proceedings," 16 Int. Insolv. Rev. (2007) 181.

21 *Ibid.* proposal #62.

22 Senate Standing Committee on Banking, Trade and Commerce, *Debtors and Creditors Sharing the Burden: A Review of the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act*, November 2003, at 158-159.

23 Bill C-12, *An Act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act, the Wage Earner Protection Program Act and chapter 47 of the Statutes of Canada, 2005*. The legislation had a long history, having been introduced through a prior bill (Bill C-55) that was passed but never proclaimed into force. For the background, see: Legislative Summary, *Bill C-12: An Act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act, the Wage Earner Protection Program Act and chapter 47 of the Statutes of Canada, 2005*, accessed online at <www2.parl.gc.ca/Sites/LOP/LegislativeSummaries>.

24 *CCAA*, ss. 6(1), 6(8), 22.1; *BIA*, ss. 54.1, 54(2)(d), 60(1.7).

25 *CCAA*, s. 9(2)(d); *BIA*, s. 178(1)(e).

26 *CCAA*, s. 2(1); *BIA*, s. 2.

27 Industry Canada, *Bill C-12: Clause by Clause Analysis*, accessed online at <http://www.ic.gc.ca/eic/site/bsf-osb.nsf/eng/br01978.html>. See, also the analysis of the earlier amendments in Bill C-55: Industry Canada, *Bill C-55: Clause by Clause Briefing Book*, accessed online at <http://www.ic.gc.ca/eic/site/cilp-pdci.nsf/eng/cl00833.html>.

TAB 8

Office of the Superintendent of Bankruptcy Canada | Bureau du surintendant des faillites Canada
An Agency of Industry Canada | Un organisme d'Industrie Canada
Canada

Summary of Legislative Changes

Summary of Key Legislative Changes in Chapter 47 of the Statutes of Canada, 2005, and Chapter 36 of the Statutes of Canada, 2007

Both the *Bankruptcy and Insolvency Act* (BIA) and the *Companies' Creditors Arrangement Act* (CCAA) are amended by Chapter 47 of the Statutes of Canada, 2005, and Chapter 36 of the Statutes of Canada, 2007 (c.47 and c.36 respectively). The legislative amendments are broad ranging and significant, and are intended to achieve the following main goals:

1. To encourage restructuring of viable businesses as an alternative to bankruptcy. In this regard, the CCAA has been significantly modified to provide increased predictability and consistency while preserving its flexibility.
2. To improve protection for workers in bankruptcy. The amendments also create the legislative framework for the Wage Earner Protection Program (WEPP), which ensures that workers whose employers are bankrupt or subject to a receivership receive compensation for their claims in a timely manner.
3. To make the insolvency system fairer and to reduce the potential for abuse. Inequities in the treatment of personal bankruptcies are addressed and the scope for abuse is curbed, while respecting the fundamental objective of providing a fresh start to the honest, but unfortunate, debtor.

On July 7, 2008, the *Wage Earner Protection Program Act*, along with a few amendments to the *Bankruptcy and Insolvency Act,* came into force. These amendments to the BIA include, but are not limited, to the following: (1) the creation of super-priorities (enhanced or higher ranking priorities) for wages and unremitted pension contributions; (2) changes to the definition of "date of the initial bankruptcy event"; (3) a reduction in the student loan debt discharge period; (4) protection of Registered Retirement Savings Plans (RRSPs); (5) the treatment of pre- and post-bankruptcy income tax refunds as part of the property of the estate; (6) the ability for creditors to realize against the property of the bankrupt without leave of the court once the trustee is discharged; and (7) the treatment of leased aircraft objects consistent with the *Convention on International Interests in Mobile Equipment* (Aircraft Equipment).

The balance of the legislative changes in c. 47 and c. 36 came into force on September 18, 2009.

A. Summary of Key Legislative Changes in Force as of July 7, 2008

Wage Earner Protection Program Act

The *Wage Earner Protection Program Act (WEPPA)* creates the Wage Earner Protection Program (WEPP), a program run by the Department of Human Resources and Skills Development Canada. The WEPP provides for payment of outstanding wages (up to the greater of $3000 or four times the maximum weekly insurable earnings under the *Employment Insurance Act*) to individuals whose employment is terminated as a result of the bankruptcy or placement into receivership of their employer. The term "wages" is defined to include salary, commissions, compensation for service rendered and vacation pay. The definition of "wages" under the WEPPA was expanded effective January 26, 2009, to include severance pay and termination pay. Employee claims are reduced by any amount paid to them by the receiver or trustee.

Trustees and receivers are required to perform numerous duties to support the operation of the program. WEPPA provisions allow the program to cover insolvency professionals' fees in certain cases and under certain conditions where there are insufficient assets to cover the costs of

Treatment of Equity Claims

Claims arising from the purchase or sale of equity of the bankrupt or debtor company are subordinated to all other claims. The class of creditors having equity claims may not vote at any meeting unless the court orders otherwise. Creditors with equity claims are not entitled to a dividend until all other claims are satisfied. No proposal or compromise or arrangement that provides for payment of an equity claim is to be approved/sanctioned by the court unless all other claims are to be paid in full.

BIA s. 2, s. 54(2)(d), s. 54.1, s. 60(1.7) and s. 140.1; CCAA s. 2, s. 6(1), s. 6(8) and s. 22.1

TAB 9

Annual Review of Insolvency Law 2007

Janis P. Sarra,

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From Subordination to Parity: An International Comparison of Equity Securities Law Claims in Insolvency Proceedings

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Abstract

Securities law claims in insolvency proceedings raise important questions of allocation of risk and remedies. In the ordinary course of business, equity claims come last in the hierarchy of claims during insolvency. What is less clear is whether this should encompass claims arising from the violation of public statutes designed to protect equity investors. Discerning the optimal allocation of risk is a complex challenge if one is trying to maximize the simultaneous advancement of securities law and insolvency law public policy goals. From a securities law perspective, there must be confidence in meaningful remedies for capital markets violations if investors are to continue to invest. From an insolvency perspective, creditors make their pricing and credit availability choices based on certainty regarding their claims and shifting those priorities may affect the availability of credit. The critical question is the nature of the claim advanced by the securities holder and whether subordination of securities law claims gives rise to inappropriate incentives for corporate officers within the insolvency law regime. A comparative analysis reveals that the U.S. has provided a limited statutory exception to complete subordination through the fair funds provision of the *Sarbanes-Oxley Act* by allowing SEC claims for penalties and disgorgement to rank equally with unsecured claims even though the funds are distributed to shareholders. The U.K. and Australian schemes permit shareholders to claim directly as unsecured creditors for fraudulent acts and misrepresentation by the issuer. In contrast, Canadian law is underdeveloped in its treatment of such claims. The paper canvasses the policy options available to reconcile securities law and insolvency law claims, including a discussion of the appropriate gatekeeping role for

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regulatory authorities and the courts, and the need for a framework that offers fair and expeditious resolution of such claims. If the public policy goal of both securities law and insolvency law is to foster efficient and cost-effective capital markets, it seems that the systems need to be better reconciled than currently. The paper also examines the codified response to the time and resources consumed in various common law tracing claims by customers in a securities firm insolvency.

I. Introduction

In an era of global capital markets, investors are seeking to maximize return and minimize risk in their investment choices. Part of that decision-making involves a choice of debt, equity and/or hybrid investments that have both debt and equity features. When companies are financially healthy, creditors can expect to receive the face value of their debt instrument plus interest and charges, while equity investors seek return through dividends from profits and appreciation in the share price. Moreover, where corporations and their officers have engaged in fraudulent disclosure (or non-disclosure), equity investors can seek to recover damages based on the loss in value of their shares resulting from the fraudulent conduct.

On insolvency, creditors rank ahead of equity investors, whose equity interests rank after creditor claims as part of the ordinary business risk that they chose. However, the question arises as to whether an equity investor's claim for fraud damages should rank after creditor claims because the damages relate to an equity interest, or whether the damages claim instead should rank *pari passu* with creditor claims because the damages relate to fraudulent conduct rather than to the fundamental nature of the equity investment. This question engages our notions of the nature of equity and debt investment, and the broader public policy question of what legal framework should govern claims arising out of violation of securities law and other fraudulent conduct when the firm is in financial distress.[1]

Securities law and insolvency law both perform important public policy functions in modern capital markets. Securities law is aimed generally at the protection of investors and the creation of efficient capital markets. Insolvency law is aimed at providing a fair and efficient mechanism for creditors to realize on their claims and at providing a framework for the rehabilitation of a company where there is a viable going forward business plan that is acceptable to creditors. In most jurisdictions, both legal regimes are enabling, in that they generally regulate only to the extent necessary to advance the public policy goals, but leave considerable room for equity investors, creditors, and corporate officers to make their own business decisions about debt or equity investments in the firm. Both regulate different aspects of the provision of capital to business enterprises and their proper functioning is important to the economy.

1. The *Sons of Gwalia* case in Australia, which is considered at length in part E of this paper, involved claims that arose out of an unfair trade practices statute rather than Australia's actual securities laws, as discussed below; *Sons of Gwalia Ltd vs. Margaretic* (2007) HCA 1.

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Securities law and insolvency law regimes intersect at the point that a firm is in financial distress and unable to pay its creditors in full. Public policy in many jurisdictions has chosen to subordinate (or "postpone" in the lingo of some countries) the damages claims of equity investors to those of regular creditors on the basis that equity investors, in seeking the unlimited upside potential of an equity investment, should be subject to the downside risks of equity, even if those risks arise as a result of the company's fraud rather than its normal market performance. Increasingly, however, the intersection of these regimes and the interests that they protect has created new tensions, in part because many jurisdictions have shifted from liquidation to restructuring regimes, in part because investors have been harmed by the misconduct of corporate officers to an extent and manner not historically considered part of ordinary business risk, and in part because many jurisdictions have made it easier for shareholders to pursue fraud claims through contingency fee or third party funding arrangements. This last point is critically important. In a "loser pays" litigation environment, shareholders simply are not going to risk their own funds seeking recovery from an insolvent company; that is why such cases are rare. However, if the lawyer takes the risk through a contingency fee, or a litigation funder takes the risk by indemnifying against costs awards, then the claims will be asserted, as is occurring in Australia. This paper begins to explore the contours of this intersection between insolvency law and securities law.

There have been an increasing number of cases in which insolvencies are either precipitated by securities law claims, or the securities claims of equity investors arise during the course of insolvency proceedings. In large measure, these claims are a function of relatively new statutory remedies granted to securities holders in the post-*Sarbanes Oxley* era of enhanced disclosure and governance requirements and of increased enforcement by securities authorities based on fraud and other misconduct.[2] In a number of jurisdictions, investors have been granted additional rights to bring civil actions against directors and officers for alleged failure to meet statutory disclosure requirements and/or fraudulent conduct. Given the nature of securities, which can be debt or equity or some combination, the treatment of these claims in insolvency proceedings has been somewhat uncertain, particularly when securities holders are aggressively pursuing remedies in the ordinary courts. Increasingly, there have been complex class action suits filed concurrently with insolvency proceedings.

Just as healthy insolvency laws help to foster robust capital markets through certainty in credit decisions, effective securities legislation is a key to enhancing global capital markets by fostering fair and efficient capital raising processes and confidence in public capital markets through the protection of investors. Yet the regimes may be in conflict in certain circumstances. For example, litigation alleging securities law violations can be complex, time-consuming, and expensive for security holders and debtors alike, and can work to defeat the goal of an expeditious resolution of a debtor's insolvency. The claims of equity securities holders create a risk to timely realization of creditors' claims at the point of firm financial distress. For jurisdictions with federal legislative

2. *Sarbanes-Oxley Act of* 2002, Pub. L. No. 107–204, 116 Stat. 745, codified in Titles 11, 15, 18, 28, and 29 U.S.C. (2002).

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structures, there also may be paramountcy questions in respect of insolvency and securities laws. At the heart of these issues is how to distribute losses during firm insolvency.

There continues to be a gap in information about the intersection of insolvency law and securities law. Both areas are highly specialized areas of practice and scholarship, each with limited understanding or sympathy for the particular policy choices of the other statutory scheme and the priority, protection, and remedies that have been fashioned to advance the particular public policy underlying the regime. Yet a better understanding of their intersection is necessary if we are to advance the goals of both regimes to stimulate robust capital markets. The tension between securities law and insolvency law has generated a number of questions. How does domestic law treat securities law claims in the context of restructuring or liquidation proceedings? Should securities law claims be dealt with in the context of insolvency proceedings or in concurrent securities regulatory proceedings? How can one protect, if possible, the reasonable expectations of both debt and equity investors in reconciling these legal regimes? Should there be different treatment of securities claims depending on whether they arise out of primary or secondary markets? The paper begins to explore these questions by examining the policy choices made by several jurisdictions.

The remainder of Part I briefly defines securities for purposes of this paper. Part II examines the treatment of securities claims in insolvency, in particular, examining when claims are subordinated or postponed and when they are not, including tensions in the allocation of risk. It considers the different judicial approaches to interpreting statutory language and the common law in the U.S., Canada, the U.K., and Australia. Part III offers several policy options for treatment of claims arising out of securities law violations.

There have also been failures of securities firms, such as brokerage companies, and the insolvency of such firms pose their own challenges, given the myriad ways that such firms hold assets for investors. The insolvency of a securities firm can raise questions regarding the nature of the assets and what may be distributable to creditors. Several jurisdictions have enacted special statutory regimes to address the insolvency of securities firms, some within existing insolvency legislation and some creating a separate, complementary, legislative scheme. Part IV examines Canada and the United States as examples of statutory regimes that have created special mechanisms for addressing securities firm insolvency. While the treatment of claims in these situations arises directly out of property and tracing claims, it is another example of where securities law and insolvency law intersect.

A. Defining securities

It is important to have a working definition of securities for purposes of the discussion here, as the nature and type of securities products is rapidly evolving and legal regimes are trying to keep pace with the developments.[3] For purposes of this paper, the definition is that used by Canadian bankruptcy and insolvency legislation, specifically,

3. For a discussion of the range of securities beyond shares or bonds, see M. Condon, A. Anand, and J. Sarra, *Securities Law in Canada* (Toronto: Emond Montgomery, 2005) at 183–191.

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"security" means any document, instrument or written or electronic record that is commonly known as a security, and includes, without limiting the generality of the foregoing, (a) a document, instrument or written or electronic record evidencing a share, participation right or other right or interest in property or in an enterprise, including an equity share or stock, or a mutual fund share or unit, (b) a document, instrument or written or electronic record evidencing indebtedness, including a note, bond, debenture, mortgage, hypothec, certificate of deposit, commercial paper, or mortgage-backed instrument, (c) a document, instrument or a written or electronic record evidencing a right or interest in respect of an option, warrant or subscription, or under a commodity future, financial future, or exchange or other forward contract, or other derivative instrument, including an eligible financial contract, and (d) such other document, instrument or written or electronic record as is prescribed.[4]

This definition captures all the instruments recognized in Canada as securities for the purpose of insolvency law. It mirrors the definition of security under securities law, including both debt and equity instruments sold or traded in the market. The definition blurs the distinction between security instruments or certificates, both the paper element and the electronic record keeping, and the actual security in the sense of a party's right, title, or interest in something. While securities law in many jurisdictions regulates debt and equity instruments together, in insolvency, debt is treated differently than equity investments, both in terms of priority of claims for payment, but also in the special treatment accorded to some forms of securities, such as eligible financial contracts. Hence, for purposes of this paper, a distinction must be made between the types of securities claims, specifically: equity claims, debt claims, and those investments that are a hybrid of debt and equity where the categorization of that investment may be a function of the status of the instrument at the time of the insolvency.

Insolvency law treatment of securities claims must also deal with the issue of beneficial securities holders. Today, public securities are almost always held electronically by central depositories or by brokerage firms, registered in the name of such firms as a mechanism to facilitate timely and efficient trading of securities. Investors are thus often only beneficial owners of the securities, not the registered owners. Both corporate laws and securities laws have undergone substantial revisions to reflect the changing nature of securities ownership, to protect such investors and to ensure that they maintain access to residual monitoring and control rights that were classically available only to registered security holders. Beneficial holders may not be readily identifiable and yet they may have a claim on the debtor's assets for the value, if any, of the security, but also in respect of the conduct of the debtor or its officers in the period leading up to opening of an insolvency or bankruptcy proceeding. Hence, when considering the intersection of securities law and insolvency law, it is important to bear in mind the many types of securities.

Where equity claims are specifically addressed in this paper, they are referred to as equity claims, whereas references to securities are a reference to the broader

4. Adopted from section 253 of the Canadian *Bankruptcy and Insolvency Act*, R.S.C. 198S, c. B-3, as amended (*BIA*).

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definition of security under the statutes. The hard definitional question is whether claims of equity security holders arising out of violations of securities law statutes should be categorized as debt or equity claims for purposes of treatment under insolvency law. It is those claims that are a primary focus of this paper.

II. Treatment of the Interests and Claims of Equity Investors During Insolvency

There is a tension between remedies under securities law and insolvency law in respect of the treatment of claims for alleged misrepresentation, failure to disclose, fraud and other violations under securities law or similar investor and consumer protection statutes. In some jurisdictions, this tension has been resolved by clear statutory language.[5] In other jurisdictions, the statutory language and recent judicial pronouncements have raised new policy issues in respect of trying to reconcile both the objectives and substantive provisions of the two regimes.[6]

Most jurisdictions follow the so-called "absolute priority rule" by providing that creditors must be paid in full in insolvency proceedings before equity holders are entitled to a distribution on their shares during insolvency. Greece, France, Germany, Brazil, Australia, the U.K., and the U.S. are just a few examples. The policy rationale is that equity investors reap the benefits of any upside value created by the wealth generating activities of a company and also take the risks associated with failure of the company. In contrast, creditors agree only to repayment of the amount owing to them plus interest. While not entitled to any profits generated, creditors do not assume the risk of loss of their investment in the same way, although arguably, at least for senior creditors, insolvency risk is factored into the pricing and availability of credit.

Insolvency law is aimed generally at maximizing the value of the estate in order to meet creditors' claims and equity holders generally rank behind creditors. Typically, there is express statutory language that specifies that shareholders' or members' interests rank after unsecured creditors.[7] There is often also statutory language specifying that shareholders are liable to pay into the insolvency estate money that they committed to subscribe for shares, which had not yet been paid at the time of the insolvency. An unpaid subscription is an asset of the estate to be realized on, and is not dependent on the status of the party who subscribed. While at common law, there were cases in which shareholders alleged they did not have to pay for subscribed shares owing, the courts generally have held that shareholders are bound to meet such obligations, as it increases the pool of capital available to creditors on liquidation.

The extensive amendments to securities laws in many jurisdictions over the last few decades have raised new issues, however, in respect of the treatment of shareholder interests. Many jurisdictions have adopted extensive continuous disclosure regimes for publicly traded companies, and provided investors with access to remedies based either on a reasonable investor test or a market impact test. Although these

5. For example, the United States.
6. For example, the U.K. and Australia, which are discussed below in Part E.
7. See for example, Germany's *Insolvenzordnung*, InsO, as amended; Thailand's *Public Companies Act*, B.E. 2535, s. 172.

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tests vary slightly in their approach, generally, jurisdictions require a company to disclose material facts, material changes or material information that might impact the value of the investment or that might influence the decisions of investors to buy, sell or hold their securities. A failure to comply with these provisions gives rise to new remedies for fraud and misrepresentation, in particular, civil remedies for a company's failure to meet statutory disclosure requirements. Given that these remedies are not the usual claims by shareholders to a residual share of the value of the assets, but rather, claims by investors for compensation for the injury to the value of their investments, the issue is whether they are "interests" to be subordinated or postponed in the same manner as equity claims when the company becomes insolvent or "claims" to be treated *pari passu* with other unsecured claims against the company.[8]

In some jurisdictions, such as the U.S., damages claims arising out of breach of statutory disclosure obligations are clearly subordinated to creditors under bankruptcy legislation. In other jurisdictions, such as the U.K. and Australia, the statutory language subordinating claims differs, and recent judgments indicate that the courts have adopted a purposive and integrative approach in trying to reconcile the securities law and insolvency law regimes. Both of these approaches are discussed below. The public policy concern is that on the one hand, creditors are entitled to some certainty in respect of where their claims are placed in the hierarchy of credit. Hence, subordinating shareholders' claims creates greater certainty and increases the pool of capital available to creditors at the point of insolvency because they do not share on a *pari passu* basis with equity investors. Creditors should reasonably expect to be paid in the normal course, but on insolvency, expect that they have access to the value of the debtor corporation to realize their claims.

On the other hand, subordinating all claims of equity investors fails to recognize that equity investors, while investing in ordinary business risk and risk of insolvency, do not assume risk of corporate fraud or violations of securities legislation, fair trade practices legislation, or criminal codes. Such subordination arguably punishes the innocent shareholder for the misconduct of corporate management, which was never part of the shareholders' bargain. Moreover, it treats shareholders' rights to statutory remedies differently in and outside of insolvency, whereas creditors do not face this differential treatment.

A. Subordination of equity claims in the United States

At first impression, the U.S. has a strict subordination regime, where shareholder claims of all types are subordinated to those of creditors. However, in the past 5 years the "shareholder claims last" policy has been tempered by the fair funds provisions of the *Sarbanes-Oxley Act*. The result overall is that while equity claims continue to be subordinated in bankruptcy proceedings, shareholders as investors can receive

8. For ease of reference, I shall refer to both insolvency and bankruptcy as insolvency, appreciating that some jurisdictions treat these as distinct phases in the debtor's financial life cycle or as applying to different types of debtors, given that in some countries, only individuals are subject to "bankruptcy" laws while corporations are separately dealt with under corporate law.

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remedies for securities law harms in some circumstances on a basis equal to unsecured creditors, as discussed below.

The absolute priority rule under the U.S. *Bankruptcy Code* clearly specifies that all creditors must be paid in full before shareholders are entitled to receive any distribution, a rule that is largely uncontested in respect of the ordinary business risk that shareholders assume in their investment decisions.[9] However, the *Bankruptcy Code* also expressly subordinates claims arising from rights to rescission and claims for damages arising from the purchase or sale of a security. Section 510(b) specifies:

> For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal to the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock.[10]

The underlying policy rationale for enacting the provision was that unsecured creditors rely generally on the equity provided by shareholder investment to assist in ensuring trade credit is repaid; shareholders invest understanding that they are undertaking a higher degree of risk and they should justifiably bear the risk of misleading or fraudulent conduct; and it is unfair to allow shareholders to make rescission claims in respect of securities fraud by the debtor such that they are competing with creditors for a limited pool of capital.[11] Equity investors enjoy the potential of substantial returns on their investment whereas creditors can realize only on the amount of their claim and the interest agreed to under the debt instrument; and the *quid pro quo* of shareholders' upside potential is that they do not rank on par with creditors in the event of insolvency and the lack of sufficient value in the assets to cover all claims. Hence, U.S. bankruptcy law allocates securities law risks in insolvency proceedings to the equity investors.

The U.S. courts have interpreted the statutory language broadly to subordinate the claims of shareholders to those of unsecured creditors, finding that claims that have a nexus or causal relationship to the purchase or sale of securities, including damages arising from alleged illegality in sale or purchase or from corporate misconduct, are to be subordinated.[12] There are judicial pronouncements to the effect

9. 11 U.S.C. §726 (applicable to Chapter 7 liquidations) and § 1129(b) (applicable to Chapter 11 reorganizations).

10. This provision was introduced in 1978. The court does, under § 510(c) of the U.S. *Bankruptcy Code* retain a power under the principles of equitable subordination, to exercise its authority to subordinate, for purposes of distribution, as discussed below.

11. For a comprehensive discussion of the policy considerations underlying enactment of the provisions, see John J. Slain and Homer Kripke, "The Interface between Securities Regulation and Bankruptcy" (1973) 48 NYU Law Review 261–300.

12. See for example, *Re Telegroup Inc.* (2002) 281 F 3d 133 (3rd Cir. U.S. Court of Appeals); *Re WorldCom* (2005) 329 BR 10 (Bankr. S.D.N.Y.); *Re Granite Partners LP* (1997) 208 BR 332 (Bankr. S.D.N.Y.); *Allen vs. Geneva Steel Co.* (2002) 281 F 3d 1173 (10th Cir. U.S. Court of Appeals); and *Re Pre-Press Graphics Inc.* (2004) 307 BR 65 (N.D. Ill.), which held that there must be some causal link between the purchase or sale and the claim at issue, but that the causal link need not arise contemporaneously with the sale or purchase of a security, at 78. Early cases had given a narrow interpretation to the scope of § 510(b) to claims arising from a purchase or sale of a security; see for example, *Re Amarex Inc.* (1987) 78 BR 605 (Bankr. WD Okla).

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that shareholders should bear the risk of illegality in the issuance of stock in the event that the issuer becomes insolvent.[13] In *Re Telegroup Inc.*, the U.S. Court of Appeals for the Third Circuit held that the statutory provisions were enacted "to prevent disappointed shareholders from recovering their investment losses by using fraud and other securities claims to bootstrap their way to parity with general unsecured creditors in a bankruptcy proceeding".[14] It held that the absolute priority rule reflects the different degree to which each party, securities holders and creditors, assumes the risk of enterprise insolvency and hence the subordinating provision is a risk allocation device, recognizing that shareholders assumed the risk of business failure by investing in equity rather than debt instruments.[15]

In *American Broadcasting Systems Inc.*, the U.S. Court of Appeals for the Ninth Circuit held that the two main rationales for the subordination of shareholder claims are the dissimilar risk and return expectations of shareholders and creditors, and the reliance of creditors on the equity cushion provided by shareholder investment.[16] The courts have held that nothing in the statutory language requires that a subordinated claimant be a shareholder, rather, the focus is on the type of claim possessed, hence parties that were induced to invest through misconduct still fall within the ambit of subordinated claims, as are those that hold on to securities based on misrepresentations.[17] The Tenth Circuit Court of Appeals in *Re Geneva Steel Co.* held that there is no good reason to distinguish between allocating the risks of fraud in the purchase of a security and post-investment fraud that adversely affects the ability to hold or sell; both are investment risks that the investors have assumed.[18] These judgments give a broad reading to the scope of § 510(b), specifically that claims arising from the purchase or sale of a security includes those involving post-issuance

13. Re PT-1 Communications, Inc. (2004) 304 BR 601 (Bankr. E.D.N.Y.); including, where the loss in value of shares was caused by a pre-purchase fraud that induced the purchase and/or a devaluing of the share due to corporate misconduct. Section 546 of the U.S. *Bankruptcy Code* provides a safe harbor for specified transactions in order to protect financial markets from the instability caused by the reversal of settled securities transactions; the proper functioning of the system, including "street-side settlement" between the brokers and the clearing agencies and "customer side settlement" between the broker and its customer, depends on guarantees of performance by all parties in the chain, *In re Enron Corp. et al vs. International Finance Corp*, interlocutory judgment by Judge Gonzalez, Case No. 01B16034 (Bankr. S.D.N.Y., 2005) at 9, citing *Jackson vs. Mishkin (In re Adler, Coleman Clearing Corp.)*, 263 B.R. 406, 476 (S.D.N.Y. 2001). The Court in *Enron* held that in enacting the § 546(e) exception to avoidance powers, the goal was to preserve the stability of settled payments and transactions (any transfer of cash or securities to complete a securities transaction) to the extent that they are not fraudulent, and where payments made for the purchase of securities were above market value, the facts as alleged in the circumstances were not sufficient to take the payments out of the realm of settlement payments commonly used in the securities industry and thus to warrant rejection of the safe harbor, *ibid.* at 10, 16.

14. Re Telegroup Inc. (2002) 281 F 3d 133 (3rd Cir. U.S. Court of Appeals) at 142, holding that "a claim for breach of a provision in a stock purchase agreement requiring the issuer to use its best efforts to register its stock and ensure that the stock is freely tradeable 'arises from' the purchase of stock for purposes of § 510(b) and therefore must be subordinated", and that "arising from" requires a nexus or causal relationship between the claim and the sale of the security, at 136, 138. Hence, the Court held that nothing in the underlying policy rationale of subordination would distinguish those shareholder claims predicated on post-issuance conduct from those shareholder claims based on conduct that occurred during the issuance itself, *ibid.* at 142.

15. Ibid. at 139.

16. American Broadcasting Systems Inc. vs. Nugent, U.S. Court of Appeals for the Ninth Circuit, Case Number 98-17133 (24 January 2001) at 1097 and the cases cited therein.

17. Ibid.

18. Allen vs. Geneva Steel Co. (2002) 281 F 3d 1173 (10th Cir. U.S. Court of Appeals) at 1180.

conduct, where there is a nexus or a casual relationship between the claim and the claimant's purchase of the debtor's securities.[19]

In *re WorldCom Inc.*, an equity securities holder alleged that his claim for damages arising from ownership of WorldCom stock should not be subordinated under § 510(b) because of the scope of fraudulent and tortious conduct by which he was harmed, arguing that § 510(b) was enacted to subordinate the normal investor risk of loss, not the claims of shareholders harmed by fraud on a massive scale.[20] The Court rejected this argument, finding that the statute does not distinguish between massive frauds and petty swindles, rather, it applies even-handedly to both; and that the degree of risk accepted by investors is irrelevant because when investors purchase stock, they agree to accept a total loss, even if they do not consciously expect it, and hence the claim was subordinated.[21]

A narrow construction of § 510(b) would limit its application to claims that arise at the time of purchase or sale of shares where there was illegal conduct in the issuance of the stock.[22] The U.S. courts are not entirely settled on the scope of § 510(b), some courts declining to subordinate claims based on wrongful misconduct that arose after the issuance of shares.[23] However, as the above cases illustrate, U.S. appellate courts for the most part have subordinated such claims.

In other instances, the courts are not settled on what is to be considered an "equity claim". For example, in *Raven Media Investments LLC* vs. *DirecTV Latin America LLC*, the District Court on appeal found that the bankruptcy court had erred in subordinating Raven Media Investments' (Raven's) contract claim pursuant to § 510(b).[24] The debtor, DirecTV Latin America, provided direct-to-home satellite television in Argentina, distributed through a local operating company, Galaxy, of which the debtor owned a 49% interest. The remaining 51% of Galaxy was owned by Plataforma Digital, a wholly owned subsidiary of Grupo Clarin, Inc. Raven was also a wholly owned subsidiary of Grupo Clarin, and under a restructuring among its subsidiaries, Plataforma's interest related to DirecTV Latin America was transferred to Raven. As the result of conflicts between Raven and DirecTV Latin America regarding operation of Galaxy, the parties negotiated a strategy to terminate their joint venture whereby a purchase price was negotiated for Raven's interest, involving a stock purchase agreement with Raven acquiring a 4% interest in DirecTV Latin America in exchange for its interest in Galaxy, a put agreement and a limited liability agreement.[25] As part of these agreements, Raven was required to sign an irrevocable proxy in favor of other DirecTV Latin America members with respect to any matter requiring a super-majority vote; Raven was not restricted from pledging its interest in

19. Re Telegroup, Inc., 281 F. 3d at 138.
20. In re WorldCom, Inc., 329 B.R. 10 (Bankr. S.D.N.Y. 2005).
21. Ibid. at 13–14.
22. Zack Christensen, "The Fair Funds for Investors Provisions of *Sarbanes-Oxley:* Is it Unfair to the Creditors of a Bankrupt Debtor?" (2005) University of Illinois L. Rev 339 at 361, citing *Re Telegroup, Inc.*, 281 F. 3d at 135; and *In re Montgomery Ward Holding Corp.* 272 B.R. 836 (Bankr. D. Del. 2001).
23. See for example, *Re Montgomery Ward Holding Corporation* 272 BR 836 (Bankr. D. el. 2001); *Re Amarex Inc.* 78 BR 605 (W.D. Oak. 1987).
24. Raven Media Investments LLC. vs. DirecTV Latin America, LLC. (2004) No. Civ. 03-981-SLR, 2004 WL 302303 (D. Del.).
25. Ibid. at 2–3.

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DirecTV Latin America; it was not to receive notice of meetings; was not consulted in any manner relating to the company's affairs and held no obligation to make capital contributions. Raven held a contract claim under the put agreement in the amount of U.S. $169 million exclusive of interest.[26]

The Court held that § 510(b) did not apply to subordinate Raven's contractual claims on the basis that Raven did not seek to hold an equity interest in DirecTV Latin America; the transaction was structured to exclude Raven's participation in management; the interest apportioned was on an arbitrary value not a valuation of the debtor; Raven was excluded from any required capital contributions; and it was not informed of the business affairs of the debtor or the exercise of its proxy. The Court held that these were not conditions consistent with the purchase of equity and the transaction was structured so that Raven would not bear the risk of illiquidity or insolvency; hence while Raven held equity in name, it possessed few characteristics associated with that status. The Court distinguished *Telegroup* in that the stock purchase agreement was structured such that Raven did not bear any risk and was allocated a specified contract price in the event of a breach, the Court finding that this price was important in light of the bootstrapping intent of the statutory provision.[27] The Court concluded that the purpose of § 510(b) was not served by imposing the risk of business failure on a party that unequivocally did not contract for it. Hence, the Court distinguished the nature of the interest in declining to subordinate the claim.

A number of U.S. scholars have been critical of the public policy reasons underlying mandatory subordination, distinguishing between risk assumed by investors for business investment and the non-assumption of risk in respect of fraudulent conduct on the part of the debtor corporation.[28] For example, Kevin Davis observes that since the subordination theory of creditor reliance was developed in the U.S., the nature of both debt and equity investment has changed; the majority of shareholders are no longer a small group of entrepreneurs; rather, they are a broadly dispersed group that cannot easily monitor officer conduct. Creditors frequently include large sophisticated financial institutions that are able to monitor the activities of corporate officers through disclosure and other covenants, and for the most part no longer include only small vulnerable trade suppliers. Hence, the comparative ability of debt and equity classes to protect themselves from fraud has shifted.[29] He suggests that the appropriate response is to compensate shareholders for fraud loss but not business loss, thus preventing after-the-fact renunciation of risk.[30] A counter-point to Davis' argument is that it is the equity investors, not the creditors that vote for the directors, who in turn select the corporate officers; and arguably, shareholders need to at least attempt to organize themselves to be effective monitors of corporate officer conduct. However, this suggestion may not be realistic, given the small proportion of

26. Ibid. at 5.
27. Ibid.; Official Committee of Unsecured Creditors vs. American Capital Financial Services, Inc. (In re Mobile Tool International, Inc.) 306 B.R. 778 (Bankr. D. Del. 2004).
28. See for example, Kevin B. Davis, "The Status of Defrauded Securityholders in Corporate Bankruptcy" (1983) Duke L.J. 1; Robert Stark, "Reexamining the Subordination of Investor Fraud Claims in Bankruptcy: A Critical Study of *In re Granite Partners*" (1998) 72 Am. Bankr. L.J. 497.
29. Ibid. at 29.
30. Ibid. at 41.

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shareholdings that most investors have at risk. Moreover, there is a further shift in the nature of corporate debt, with financial institutions such as banks generally holding less corporate debt and hedge funds that have varying monitoring capacities holding more corporate debt.

The U.S. *Bankruptcy Code* also authorizes the court, under the principles of equitable subordination, to subordinate for the purposes of distribution of all or part of an allowed claim or interest.[31] The courts have held that they will look to the nature and substance of the claim and not the form, and that there are three prerequisites: the claimant must have engaged in some type of inequitable conduct; the misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and equitable subordination of the claim must not be inconsistent with the provisions of the *Bankruptcy Code*.[32] As a general rule, courts prefer the claims of innocent unsecured creditors over the claims of shareholders deceived by officers of the corporation; however, in the case of stock redemption, the courts look at the substance of the transaction, in deciding to subordinate equitably the claims of a former shareholder turned creditor to the claims of general unsecured creditors.[33]

Hence, while there is clearly statutory language subordinating equity claims in the U.S., the debate regarding the scope of that subordination is not entirely settled. Moreover, new remedies available to investors through the enforcement activities of securities regulators have altered the absolute subordination regime, as discussed in the next part.

B. Tensions in the allocation of risk: *Sarbanes-Oxley's* fair funds for investors provision and subordination of claims under the U.S. *Bankruptcy Code*

U.S. securities law has provided for civil remedies for claims of misrepresentation, fraudulent conduct, and other violations of securities laws for a number of years. As a consequence, there have been a number of class actions against corporations, which either precipitate firms filing U.S. *Bankruptcy Code* Chapter 11 proceedings or liquidation proceedings, or that arise once the conduct of officers becomes known in a bankruptcy proceeding. The vast majority of these cases settle before judgment. While the claims under the settlement are subordinated under U.S. bankruptcy law, remedies under the *Sarbanes-Oxley Act of 2002* have given rise to new indirect remedies to equity investors for

31. Section 510(c), U.S. *Bankruptcy Code*. Under § 510(c) of the U.S. *Bankruptcy Code*, the court retains a power under the principles of equitable subordination, to exercise its authority to subordinate, for purposes of distribution, all or part of an allowed claim or interest to all or part of another allowed interest.

32. In re Mobile Steel Co., 563 F. 2d 692 (5th Cir. 1977); *In re Structurlite Plastics Corporation*, 224 B.R. 27; 1998 Bankr. LEXIS 1038, 1998 FED App. 0015P (6th Cir.). However, Christensen has observed that some courts have held that inequitable conduct on the part of the claimant is not always a necessary element for a remedy of equitable subordination; Christensen, *supra*, note 22 at 374.

33. In re Structurlite Plastics Corporation, ibid. at 12; in which a creditor and an unsecured creditors' committee of the debtor filed an action against the former shareholders of the debtor in a failed LBO. The debtor had borrowed money and then loaned it to the purchaser so that the purchaser could pay the former shareholders. On appeal of the summary judgment granted in favor of the creditor and the unsecured creditors' committee, the Court held that the creditor and the unsecured creditors' committee had standing to assert the fraudulent conveyance claims under 11 U.S.C.S. § 544(b) and Ohio Rev. Code Ann. § 1336.04 (repealed 1990). The Court held that the bankruptcy court's subordination of the former shareholders' claims to the claims of general unsecured creditors was not an error.

harms caused by securities law violations. The *Sarbanes-Oxley Act* was enacted in response to corporate scandals and considerable public pressure to respond to the harms caused by massive frauds perpetrated by U.S. companies. It represents the particular nature of U.S. democracy in that it was a rapid response to severely shaken markets and the result of intense lobbying to address the weaknesses in U.S. securities law and the consequent harms.

In the U.S., the subordination of equity claims has been tempered in the case of securities fraud by the ability of investors to receive compensation under powers granted to the Securities Exchange Commission (SEC) under the *Sarbanes-Oxley Act*. The SEC is given express power to distribute payments to investors as part of the "fair funds for investors" civil penalty and disgorgement powers.[34] The fair funds provisions have been successfully used to return at least some of the losses to investors. In 2005, $1.9 billion in disgorgement and penalties was ordered, 96% of which was collected; in 2006, $1.2 billion was ordered, 82% of which was collected.[35] While many cases do not involve bankruptcy proceedings, a number do.

Section 308(a) of the *Sarbanes-Oxley Act* allows civil penalties to be added to disgorgement funds for the relief of victims of securities fraud, allowing the SEC to distribute both the civil penalties and disgorgement funds created under the *Sarbanes-Oxley Act* from the assets of the bankruptcy estate to investors.[36] SEC claims rank equally with those of unsecured creditors in a bankruptcy or reorganization proceeding. Previously, civil penalties could only be paid to the U.S. Treasury. The fair funds provision allows investors wronged by securities law violations to recover at least a portion of their losses from the fraudulent conduct of the debtor by route of the SEC's lawsuit against the debtor corporation.[37] Hence, while a shareholder's claim is subordinated pursuant to § 510(b) of the U.S. *Bankruptcy Code*, the investor may be eligible for a distribution pursuant to the fair funds for investors provision under the *Sarbanes-Oxley Act* from the bankrupt's assets indirectly through the SEC. Arguably, this eligibility creates a tension in reconciling the public policy objectives of these two statutes.[38]

34. Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745, codified in Titles 11, 15, 18, 28, and 29 U.S.C. (2002) at section 308. For a discussion, see Christensen, *supra*, note 23; Marvin Sprouse and Jackson Walker, "A Collision of Fairness: *Sarbanes-Oxley* and § 510(b) of the *Bankruptcy Code*" (2005) 24 American Bankruptcy Institute Journal 8.

35. Christensen, *ibid.* at 56. Compensation to investors is a secondary function and the primary objective of the provisions is deterrence. The SEC also has authority to impose civil penalties in the same action, based on the degree of inappropriate conduct, however, these penalties are not available to investors as compensation for harms caused by the bankrupt's conduct.

36. Section 308(a) specifies: "If in any judicial or administrative action brought by the Commission under the securities laws (as such term is defined in § 3(a)(47) of the *Securities Exchange Act of 1934* (15 U.S.C. 78(c)(a)(47)) the Commission obtains an order requiring disgorgement against any person for a violation of such laws or the rules or regulations thereunder, or such person agrees in settlement of any such action to such disgorgement, and the Commission also obtains pursuant to such laws a civil penalty against such person, the amount of civil penalty shall, on the motion or at the direction of the Commission, be added to and become part of the disgorgement fund for the benefit of the victims of such violation".

37. See for example, *S.E.C. vs. Lybrand*, 281 F. Supp. 2d 726 (S.D.N.Y. 2003) at 727; *S.E.C. vs. Giesecke*, Accounting and Auditing Enforcement Release No. 1636 (25 September 2002).

38. The SEC already has had the ability under the U.S. *Bankruptcy Code* to enforce securities law even if the debtor was in bankruptcy proceedings, although the statute prohibits it from enforcing a money judgment outside of the bankruptcy proceedings and recovery of the penalty amounts may only occur through the final bankruptcy distribution. This exemption from the usual stay provisions recognizes the public policy underpinning securities law enforcement activities; section 362(b), *Bankruptcy Code*.

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The fair funds provision was enacted as further recognition of the SEC's authority to create equitable remedies, including disgorgement orders that obligate the surrender of profits and interest acquired in violation of securities law.[39] The provision allows the SEC to enhance its enforcement of securities law and to seek remedies that will serve as a deterrent to fraudulent conduct by issuing corporations. The amount of civil liability that the SEC will seek to impose depends on the egregiousness of the issuer's conduct, the degree of its scienter, whether the conduct created substantial losses or risk of losses to others, whether the conduct was of a recurring nature, and the debtor's current and anticipated financial condition.[40] The SEC may seek orders requiring parties to disgorge any money obtained through wrongdoing and is empowered to seek civil penalties for violations of securities laws.[41] Disgorgement is an equitable remedy that requires the corporation or party that engaged in fraudulent activities to give up the amounts by which they were unjustly enriched by the wrongful conduct. While the SEC bears the burden of proving that the amount sought is appropriate, the courts have held that the amount of disgorgement need only be "a reasonable approximation of profits causally connected to the violation".[42]

In a bankruptcy proceeding, the SEC's civil action is frequently settled and in such cases, the court must approve the settlement. The court determines whether the proposed settlement is fair and equitable and in the best interests of the estate, and the court must be assured that it does not fall below a range of reasonableness. Where the SEC has received a judgment for civil penalties and disgorgement, either on a settlement basis or after litigation, the amount ordered by the court is the SEC's claim against the estate of the debtor corporation and it ranks with ordinary creditors, above equity claimants. Under Chapter 11 *Bankruptcy Code* proceedings, the debtor is discharged from the SEC's monetary penalty on confirmation of a plan of reorganization; however, the debtor must pay the SEC a percentage of the penalty equal to the percentage received by unsecured creditors under the reorganization plan.

The fair funds provision allows the SEC to provide restitution to defrauded shareholders. Where appropriate, the SEC has returned disgorged funds to harmed investors and, as a result of the fair funds provision of the *Sarbanes-Oxley Act*, has used amounts paid as penalties to reduce losses to injured parties.[43] Hence, funds that previously were realized and went to the U.S. treasury are now available through the disgorgement fund to be distributed to investors who were harmed by the fraudulent conduct of the debtor corporation.

In *SEC v. WorldCom*, the Southern District of New York Court approved a settlement where WorldCom had engaged in a massive accounting fraud of more than U.S. $3

39. SEC, *2006 Performance and Accountability Report* http://www.sec.gov/about/secpar/secpar2006.pdf at 56.

40. S.E.C. vs. Kane, 2003 U.S. Dist. LEXIS 5043 (S.D.N.Y. 2002) at 11; *S.E.C. vs. Credit Bancorp, Ltd.*, 2002 U.S. Dist. LEXIS 20597 (S.D.N.Y. 2002) at 9.

41. SEC, *2006 Performance and Accountability Report, supra*, note 39 at 56.

42. S.E.C. vs. Patel, 61 F. 3d 137, 139 (2d Cir. 1995).

43. SEC, *2006 Performance and Accountability Report, supra*, note 39 at 56. Funds not returned to investors are sent to the treasury.

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billion.[44] The SEC action had been filed almost 1 month before WorldCom filed for Chapter 11 protection and the SEC action and the Chapter 11 proceeding were being conducted concurrently.[45] Settlement of the case involved two rulings. The first ruling was injunctive relief, including review of WorldCom's corporate governance systems and accounting policies and controls, with education to reduce risk of further violations.[46] In the second ruling, the SEC secured an injunction against WorldCom and proposed a settlement agreement whereby the SEC would impose a U.S. $2.25 billion monetary penalty (40% of the estimated liquidation value of WorldCom), which would be satisfied by a U.S. $750 million payment from the bankruptcy estate, comprised of U.S. $500 million cash payment and U.S. $250 million in the reorganized company's common stock. The Court held that the amount was aimed at ensuring that there was sufficient penalty to deter the officers from future fraudulent conduct while also ensuring that the corporation was able to reorganize.[47] The settlement expressly provided that the settlement assets would be directed to defrauded shareholders pursuant to the fair funds for investors provision of *Sarbanes-Oxley*. In approving the settlement, Judge Rakoff observed that the SEC had authority to seek a civil penalty for the full value derived from WorldCom's fraud, an estimated U.S. $10–17 billion and that a penalty of that magnitude would necessarily destroy the company to the detriment of some 50 000 innocent employees.[48]

The Court in *WorldCom* recognized the potential conflict between the fair funds for investors provision of the *Sarbanes-Oxley Act* and the U.S. *Bankruptcy Code*, observing that a civil penalty imposed by the SEC premised primarily on compensating defrauded shareholders might arguably run afoul of the provisions of the *Bankruptcy Code* that subordinate shareholder claims below all others. The Court held that compensation is a secondary goal to deterrence, but that the SEC could rationally take account of shareholder loss as a relevant factor in formulating the size and nature of the penalty and it could distribute the settlement amount from civil penalties to investors.[49] In the bankruptcy proceedings of WorldCom, Judge Gonzalez approved the settlement with the SEC pursuant to Federal Rule of Bankruptcy Procedure 9019, based on the creditors' committee support for the settlement, the risk of an even greater penalty if the amount were litigated to judgment, and the uncertainty in the priority issue as between the two statutory regimes. While noting the apparent conflict between the two statutes, the Court held that "in considering approval of a settlement, the court is not required to resolve the underlying legal issues related to

44. SEC vs. WorldCom 273 F. Supp. 2d 431 (S.D.N.Y. 2003).

45. The SEC commenced the civil action on 26 June 2002 in the U.S. District Court for the Southern District of New York against WorldCom alleging massive accounting fraud and WorldCom filed for Chapter 11 protection on 21 July 2002, given the size of the SEC's claims.

46. David Henry, "Subordinating Subordination: WorldCom and the Effect of *Sarbanes-Oxley's* Fair Funds Provision on Distributions in Bankruptcy" (2004) 21 Emory Bankruptcy Developments Journal 259 at 294.

47. SEC vs. WorldCom 273 F. Supp. 2d 431 (S.D.N.Y. 2003) at 435. The settlement amount was 75 times greater than any prior penalty for accounting fraud.

48. Ibid.

49. Ibid.

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the settlement" and it did not "fall below the lowest point in the range of reasonableness".[50] The Court held that the SEC had taken adequate account of the magnitude of the fraud and the need for deterrence, while fairly and reasonably reflecting the realities of a complex situation.[51]

Thus in *WorldCom*, while the court was not required to determine the conflict between the two statutes, it did recognize the tension and balanced the interests at stake in finding the settlement appropriate. The outcome is that shareholders realized some value on their losses indirectly through the SEC's action.

In *Adelphia*, the SEC asserted claims for disgorgement of profits and for civil penalties based on fraud and accounting irregularities.[52] The bankruptcy court was asked to endorse a comprehensive settlement proposal that would require Adelphia to contribute U.S. $715 million to a restitution fund in exchange for the Department of Justice not instituting criminal action and the SEC dropping its claims against the corporation and its subsidiaries. Although creditors objected to the proposed settlement based on an alleged violation of the absolute priority rule, the Court held that § 510(b) did not prohibit the settlement since shareholders would not be sharing in the assets of the estate under a plan, but rather sharing in a fund created and owned by the government, and that the subordination provision does not apply to assets belonging to the government.[53] While defrauded equity holders would have to confront the absolute priority rule and § 510(b) when trying to share in the assets, that issue was far removed from the request to approve the settlement.[54] The Court approved the settlement on the basis that it was reasonable.

The outcome of these judgments has been contested. Sprouse and Walker have observed that in most cases the claims of shareholders are at the lowest end of the distributive priority spectrum established by the *Code*, arguing that if the SEC is able to fund the fair fund for investors program with civil penalties imposed on a bankruptcy estate for the benefit of interest-holders, such action runs afoul of § 726(a)(4), depending on whether an SEC penalty is characterized as "compensation for actual pecuniary loss". They observe that § 726(a)(4) is operative in the Chapter 11 context in that a plan may not be approved over the objection of an impaired class of claims or interests if the creditors in that class are to receive less than a liquidation distribution.[55]

However, David Henry has suggested that the court's application of the fair funds provision is correct, and while it may be contrary to the theory underlying the absolute

50. S.E.C. vs. WorldCom Inc., 273 F. Supp.2d 431 (S.D.N.Y. 2003) at 435; *In re WorldCom Inc.*, Ch. 11 Case No. 02-13533, Docket # 8125 (Bankr. S.D.N.Y. 6 August 2003). *S.E.C. vs. WorldCom Inc.*, Litigation Release No. 17588 (Civil Action 02 CV 4963 (S.D.N.Y.) (27 June 2002)), available at www.sec.gov/litigation/litreleases/lr17588.htm.

51. S.E.C. vs. WorldCom Inc., 273 F. Supp.2d 431 (S.D.N.Y. 2003) at 436.

52. In re Adelphia Communications Corp., 327 B.R. 143, 149 (Bankr. S.D.N.Y. 2005).

53. The Court held that the settlement was proposed pursuant to Federal Rule of Bankruptcy Procedure, *ibid.*

54. Ibid. at 169.

55. Sprouse and Walker, *supra*, note 34 at 12, citing *In re WorldCom Inc.*, Ch. 11 Case No. 02-13533 (Bankr. S.D.N.Y. 21 July 2002 (petition date)); *In re Adelphia Communications Corp.*, Chapter 11 Case No. 02-41729 (Bankr. S.D.N.Y. 25 June 2002 (petition date)). They also note that: "in a chapter 7 case, §726(a)(4) of the *Code* provides that distributions of estate property for allowed claims based on fines or penalties that are 'not compensation for actual pecuniary loss" hold a lower distributive priority vis-a-vis allowed general unsecured claims'.

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priority rule and subordination of shareholder claims, it is a proper application of securities law and treatment of funds arising from securities law fraud claims; and that this recognition of the importance of securities law enforcement allows shareholders to recover losses from fraud on a *pari passu* basis with the claims of unsecured creditors.[56] He also observes that the absolute priority rule is often ignored in bankruptcy proceedings in order to allow parties the flexibility of shifting assets to those most deserving and hence it is not really a justification for refusing to recognize shareholder claims in specified circumstances. Henry suggests that the fair funds provisions is an expression of Congress' objective of ensuring that at least some portion of penalties realized on securities fraud is available for distribution to wronged investors.[57] Moreover, he argues that while shareholders may agree to ordinary risk of business loss from their investment, they are not agreeing to assume the extraordinary risk of business fraud loss; and that both creditors and investors are limited in their ability to monitor against fraudulent activities and both should share in the risk.[58]

In sum, subordination of equity claims and § 510(b) of the U.S. *Bankruptcy Code* has been tempered by the *Sarbanes-Oxley* fair funds provision.[59] While equity investors continue to have their right to distributions of their shares subordinated under ordinary business risk principles, the fair funds process creates a public policy mechanism aimed at deterring corporate misconduct and at allocating proceeds recovered from such harms to those harmed through distribution of disgorgement and civil penalties funds. This mechanism of indirect redress for harms is distinguishable from granting equity investors direct remedies for harms arising out of statutory violations during insolvency proceedings, which is not a public policy choice that the U.S. has made. The fact that investors realize only through the enforcement activities of the SEC means that the SEC acts in a gatekeeping role in respect of these claims, addressing the arguments that equity investors would somehow use securities claims to bootstrap their position on liquidation. The SEC's primary function in seeking disgorgement and civil penalties is the deterrence objective. While secondary, compensation to investors does appear to have assisted in meeting the public policy goals of securities laws, while continuing to observe the public policy goals of insolvency law. One issue that deserves further examination is precisely how disgorgement from the company creates a deterrent effect on corporate officers, unless their own personal wealth is also disgorged where they have engaged in fraud. While arguably there are reputational losses and sometimes criminal sanctions, it would seem that financial forfeiture of personal gains from misconduct would be an effective way in which future misconduct by these or other officers is discouraged.

C. The treatment of equity claims in Canada

In Canada, there is not yet express statutory language regarding equity claims in either the *Bankruptcy and Insolvency Act* or the *Companies' Creditors Arrangement Act*

56. Henry, supra, note 46 at 297.
57. *Ibid.*
58. *Ibid.* at 299.
59. The absolute priority rule does not subordinate shareholder claims, but rather, applies only to distributions to shareholders on their shares, not to any damages claims, which is why 510(b) was enacted.

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(*CCAA*); and equity claims have been subordinated to creditor claims under general corporate law and common law principles.[60] Equity investors are not entitled to share in the assets of an insolvent corporation until after all the ordinary creditors have been paid in full.[61] The courts will consider the true nature of a transaction and the surrounding circumstances to determine whether a claim is a claim provable in bankruptcy or restructuring proceedings, specifically, whether the true nature of the relationship is that of an equity investor or a creditor owed a debt.[62] In the context of restructuring proceedings, Canadian courts have held that where there is no equity value left in the debtor corporation, shareholders will not be allowed to hinder the wishes of creditors as to the outcome of the proceeding.[63] In *Re Canadian Airlines Corp.*, the Court held that where a corporation is insolvent, on liquidation the shareholders would get nothing, and that in such circumstances, there is nothing unfair or unreasonable in the court approving a restructuring plan without shareholder approval, as it would be unfair to the creditors and other stakeholders to permit the shareholders, whose interest has the lowest priority, to have any ability to block a reorganization.[64]

The underlying policy rationale is that shareholders are at the bottom of the hierarchy of claims during an insolvency or bankruptcy proceeding and where there is not sufficient value to meet the claims of unsecured creditors, there is clearly no residual value for equity claims and hence they should not be given a vote in the proceedings.[65] While courts will consider the interests of equity investors along with other stakeholders such as employees, trade suppliers, and local communities that are dependent on the economic activity of the debtor corporation, this is a public interest

60. Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, as amended (*CCAA*). *Re Central Capital Corporation* (1996), 132 D.L.R. (4th) 223 (Ont. C.A.) at 245; *Canada Deposit Insurance Corp.* vs. *Canadian Commercial Bank* (1992), 97 D.L.R. (4th) 385 (S.C.C.) at 402–408.

61. Re Royal Oak Mines Inc. (1999), 14 C.B.R. (4th) 279 (Ont. S.C.J. (Commercial List)); *Re Central Capital Corporation, ibid.* at 245. For example, s. 211 (7) of the *Canada Business Corporations Act* (*CBCA*) R.S.C. 1985, c. C-44, as amended, specifies that when a corporation intends to liquidate, the corporation is to send notice to creditors; proceed to collect its property and discharge all its obligations and to do all other acts required to liquidate its business; and after adequately providing for the payment or discharge of all its obligations, distribute its remaining property, either in money or in kind, among its shareholders according to their respective rights, codifying the hierarchy of claims on liquidation.

62. Canada Deposit Insurance Corp. vs. Canadian Commercial Bank (1992), 97 D.L.R. (4th) 385 (S.C.C.) at 402, 406, 408. In *Canada Deposit Insurance,* the Supreme Court of Canada held that emergency financial assistance provided to the Canadian Commercial Bank by a group of lending institutions and government was properly categorized a loan for the purpose of determining whether the group was entitled to rank *pari passu* with unsecured creditors in an insolvency. The Court found that the arrangement was hybrid in nature, combining elements of both debt and equity, it was in substance a loan and not a capital investment as the equity component of the arrangement was incidental and had never come into effect, and the parties' agreements supported the characterization of the arrangement as a loan. See also *National Bank of Canada* vs. *Merit Energy Ltd.*, 2001 CarswellAlta 913 (Alta. Q.B.).

63. Re Canadian Airlines Inc (2000) A.J. No. 771 (2000), 9 B.L.R. (3d) 41 (Alta Q.B.) at 76; *Re Loewen Group Inc.* (2001), 22 B.L.R. (3d) 134 (Ont. S.C.J. (Commercial List); *Fiber Connections Inc.* (2005), 5 B.L.R. (4th) 271; Janis P. Sarra, *Rescue! The Companies' Creditors Arrangement Act* (Toronto: Carswell, 2007).

64. Re Canadian Airlines Inc., ibid. at para. 76.

65. Courts have relied on corporate law provisions. For example, section 191 (1) of the *Canada Business Corporations Act* R.S.C. 1985, c. C-44, as amended, (*CBCA*) defines reorganization to include a court order under the *BIA* approving a proposal or any other statute that affects the rights among the corporation, its shareholders and creditors. It grants the court authority to make orders approving reorganizations, including authorize the issue of debt obligations of the corporation, whether or not convertible into shares of any class or having attached any rights or options to acquire shares of any class, and fix the terms thereof; s. 191 (3), *CBCA. Re Canadian Airlines Inc., ibid.; Re T. Eaton Co.* (1999) O.J. No. 5322 (Ont. S.C.J. (Commercial List)).

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consideration as opposed to recognizing equity claims as having a determinative status.[66] Where, however, there is still equity value remaining, either in the form of going forward equity or in the tax losses associated with the insolvency, shareholders may be given a vote in a restructuring proceeding.[67]

In *Re Central Capital Corporation*, the Ontario Court of Appeal observed that holding that the appellants do not have provable claims accords with sound corporate policy and that on insolvency, the claims of creditors rank ahead of the claims of shareholders for the return of their capital. Case law and statute law protect creditors by preventing companies from using their funds to prejudice creditors' chances of repayment, given that creditors rely on these protections in making loans to companies.[68] In *Central Capital Corporation*, the Court of Appeal held that a relationship between preferred shareholders and the corporation had the characteristics of both debt and equity; however, in substance, the preferred shareholders were shareholders and the existence of retraction rights did not change them into creditors. The Court held that the preferred shareholders had agreed to take preferred shares instead of another type of instrument, such as a bond or a debenture, and there was no evidence to support their contention that by taking the preferred shares they were extending credit to the debtor corporation; moreover, their interest was listed as capital on the company's financial statements.[69] Thus, the Court determined the case on the nature of the relationship.

Currently, Canadian legislation is not completely silent on the treatment of equity claims.[70] Under most Canadian corporations statutes, a plan of reorganization or

66. For a discussion, see Janis Sarra, *Creditor Rights and the Public Interest, Restructuring Insolvency Corporations* (Toronto: University of Toronto, 2002).

67. Re T. Eaton Co. (1999) O.J. No. 5322 (Ont. S.C.J. (Commercial List)) where the Court noted at para. 10 treatment of shareholder claims in several cases: "I think it appropriate to note that in Sammi Atlas, the shareholder got $1.25 million U.S.; in Cadillac Fairview Inc. nothing; and in Royal Oak it is proposed the shareholders be diluted down to 1% equity interest underneath a heavy blanket of other obligations. When viewed in contrast, the Eaton's deal would appear to be on the rich side". The Court took into consideration the fact that both classes of creditors as well as the shareholders voted overwhelmingly in favor of the Eaton's Plan, the unsecured creditors were 99% in support and the shareholders 99.5% in support, at para. 7. In approving a plan under the *CCAA* and in exercising its discretion to approve an arrangement under the Ontario *Business Corporations Act*, the Court in Eaton held that it must be satisfied that the arrangement meets the same criteria as set out above for approving a plan under the *CCAA*, specifically, the fairness and reasonableness of a plan. The Court held that it does not require perfection; nor will the court second guess the business decisions reached by the stakeholders as a body. The Court observed that many of the shareholders have suffered significant losses as a result of the demise of Eaton's, however, it held that it was important for at least future situations that in devising and considering plans persons recognize that there is a natural and legal "hierarchy of interest to receive value in a liquidation or liquidation-related transaction" and that in that hierarchy the shareholders are at the bottom. However, in the circumstances here prevailing, the Court held that the plan was fair and reasonable.

68. Re Central Capital Corporation (appeal judgment), *supra*, note 60, concurring opinion of Laskin, JA, at 274.

69. Under the Canada *Business Corporations Act*, an insolvent corporation is prohibited from redeeming shares and hence the shareholders had no right to enforce payment.

70. The *BIA* currently distinguishes claims made under transactions that seek repayment in the form of profits. Section 139 of the *BIA* specifies that where a lender advances money to a borrower engaged or about to engage in trade or business under a contract that the lender is to receive a rate of interest varying with profit or a share of profits, the lender is not entitled to any payment in respect of the loan until the claims of all other creditors have been satisfied. Essentially, the lender is considered a silent partner for purposes of the provisions. However, if the lender holds security for its claim, it is entitled to enforce it L. Houlden, G. Morawetz, and J. Sarra, *The 2007 Annotated Bankruptcy and Insolvency Act* (Toronto: Carswell, 2006) at 668; *Sukloff vs. A.H. Rushforth & Co.* (1964), 6 C.B.R. (N.S.) 175 (S.C.C.). Where shareholders lent money to a debtor but did not receive a rate of interest varying with profit or sharing profits, subordination has been found not to apply: *Re Provost Shoe Shops Ltd.* (1993), 21 C.B.R. (3d) 108, 340 A.P.R. 302 (S.C.).

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plan of arrangement can restructure equity without a shareholder vote if the equity investment has no value.[71] These provisions come into play where there is a condition of insolvency.

In the context of restructuring proceedings, Canadian courts have held that where shareholder interests are "under water" or "below the Plimsoll line", that is, that there is no equity value left in the debtor corporation, shareholders will not be allowed to vote on a restructuring plan or a proposal and will not be allowed to hinder the wishes of creditors as to the outcome of the proceeding or the specific proposal or plan of arrangement and compromise.[72] In a corporate plan of arrangement or reorganization, the court has authority to do by order something that usually requires a shareholder vote, and the court can decide whether or not to exercise its authority to make such an order.[73] Unlike a Chapter 11 debtor in the U.S., a Canadian debtor corporation must meet an insolvency test before it can have access to insolvency legislation; hence the interests of equity investors are most often already under water at the point that the debtor filings insolvency proceedings.

Re Blue Range Resource Corp. was the first Canadian case that dealt directly with the issue of whether an equity investor in a takeover bid, allegedly induced by fraud to purchase shares of a debtor corporation, was able to assert its claim in such a way as to achieve parity with other unsecured creditors in a *CCAA* proceeding.[74] The Alberta Court of Queen's Bench considered the treatment of shareholder claims for negligent misrepresentation, addressing the question of whether the treatment of such claims differed from the risks of ordinary business investments.[75] *Blue Range* involved an application for determination of whether Big Bear Exploration Ltd.'s claim should rank equally with claims of unsecured creditors. Big Bear had succeeded in a takeover bid for Blue Range Resource Corp. by way of exchange of shares and claimed that its decision to undertake the takeover was made in reliance on information publicly disclosed by Blue Range regarding its financial situation. After the takeover, it discovered that the information disclosed by Blue Range was misleading and that the

71. Where a corporation is insolvent, defined in s. 192(2) of the *CBCA* as where it is unable to pay its liabilities as they become due; or where the realizable value of the assets of the corporation are less than the aggregate of its liabilities and stated capital of all classes, where it is not practicable for a corporation that is not insolvent to effect a fundamental change in the nature of an arrangement under any other provision of this Act, the corporation may apply to a court for an order approving an arrangement proposed by the corporation; s. 192(3), *CBCA*. The court has the authority under s. 192 to may make any interim or final order it thinks fit including, dispensing with notice requirements, appointing representative counsel, an order requiring a corporation to call, hold, and conduct a meeting of holders of securities or options or rights to acquire securities in such manner as the court directs; an order permitting a shareholder to dissent under section 190; and an order approving an arrangement as proposed by the corporation or as amended in any manner the court may direct.

72. See for example, *Re Canadian Airlines Inc.* (2000), 9 B.L.R. (3d) 41 (Alta Q.B.) at 76; *Re Loewen Group Inc.* (2001), 22 B.L.R. (3d) 134 (Ont. S.C.J. (Commercial List); *Fiber Connections Inc.* (2005), 5 B.L.R. (4th) 271; Janis P. Sarra, *Rescue! The Companies' Creditors Arrangement Act* (Toronto: Carswell, 2007).

73. In *Re T. Eaton Co.* (1999) O.J. No. 5322 (Ont. S.C.J. (Commercial List)), the Court held at para. 2 that: "In exercising its discretion to approve an arrangement under the Ontario *Business Corporations Act* (OBCA), the court must be satisfied that the arrangement meets the same criteria as set out above for approving a plan under the *CCAA*". See also Olympia & York Developments Ltd. (1993) 18 C.B.R. (3d) 176 (Ont. Gen. Div.) at 186.

74. Re Blue Range Resource Corp., 2000 CarswellAlta 12, 15 C.B.R. (4th) 169 (Alta Q.B.).

75. Re Blue Range Resource Corp., ibid.

Blue Range shares were essentially worthless. As sole shareholder, Big Bear caused the company to apply for protection under the *CCAA*.[76]

The first issue was whether Big Bear's claim was as an unsecured creditor of Blue Range that ranked equally with the unsecured creditors or whether its claim was as a shareholder of Blue Range that ranked after the unsecured creditors.[77] The Court held that the nature of Big Bear's claim against Blue Range for an alleged share exchange loss, transaction costs, and cash share purchase damages was in substance a claim by a shareholder for a return of what it invested *qua* shareholder, and hence the claim ranked after the claims of unsecured creditors.[78]

The Court held that the very core of the claim was the acquisition of Blue Range shares by Big Bear and whether the consideration paid for such shares was based on misrepresentation. It held that Big Bear had no cause of action until it acquired shares of Blue Range, which it did through share purchases for cash prior to becoming a majority shareholder. The Court concluded that the tort claim derived from Big Bear's status as a shareholder, and not from a tort unrelated to that status.[79] The claim for misrepresentation was hybrid in nature and combined elements of both a claim in tort and a claim as shareholder, and hence the Court observed that it must determine what character it had in substance. The Court found that it was not a claim for return of capital in the direct sense; rather, it was a claim for an award of damages measured as the difference between the "true" value of Blue Range shares and their "misrepresented" value, "in other words, money back from what Big Bear 'paid' by way of consideration".[80] The Court held that a tort award to Big Bear could only represent a return of what Big Bear invested in equity of Blue Range and that it is that kind of return that is limited by the basic corporate law principle that shareholders rank after creditors in respect of any return on their equity investment. It observed that Big Bear acquired not only rights but also restrictions under corporate law when it acquired the Blue Range shares. The Court found that the alleged share exchange loss derived from and was inextricably intertwined with Big Bear's shareholder interest in Blue Range, and thus that the nature of the claim was in substance a claim by a shareholder for a return of what it invested as shareholder, rather than an ordinary tort claim.[81]

The Court held that it was clear that in common law shareholders are not entitled to share in the assets of an insolvent corporation until after all the ordinary creditors

76. Big Bear, as the sole shareholder of Blue Range, entered into a Unanimous Shareholders' Agreement (USA) pursuant to which Big Bear replaced and took on all the rights, duties and obligations of the Blue Range directors and using its authority under the USA, Big Bear caused Blue Range to apply for protection under the *CCAA; Re Blue Range Resource Corp. ibid.* Big Bear made an unsecured claim for the value of shares exchanged in the takeover bid, pursuing the claims through two different routes: by filing notice of claim for damages for share exchange loss, and filing a statement of claim alleging other causes of action. The Alberta court made orders that precluded Big Bear from advancing claims beyond those set out in notice of claim and Big Bear sought an expedited trial for hearing the claim.

77. Ibid. The applicants were the Creditors' Committee of Blue Range and Enron Canada Corp., a major creditor.

78. 14.

79. Ibid. at para. 22.

80. Ibid. The Court held that while the matter was complicated by reason that the consideration paid for Blue Range shares by Big Bear was Big Bear treasury shares, the notice of claim quantified the loss by assigning a value to the treasury shares.

81. Ibid. at para. 25.

have been paid in full.[82] In that sense, Big Bear acquired not only rights but also restrictions under corporate law when it acquired the Blue Range shares. The Court relied on the fundamental corporate principle that claims of shareholders should rank below those of creditors on insolvency, finding that even though this claim is a tort claim on its face, it is in substance a claim by a shareholder for a return of what it paid for shares by way of damages.[83]

The Court in *Blue Range* observed that a restructuring plan under the *CCAA* does not provide a statutory scheme for distribution, as it is based on the premise that a plan of arrangement will provide a classification of claims that will be presented to creditors for approval. Creditors conduct business with corporations on the assumption that they will be given priority over shareholders in the event of an insolvency. The Court held that the identification of risk-taking assumed by shareholders and creditors was illustrated by the behavior of Big Bear in that in the course of Big Bear's hostile takeover of Blue Range, it sought access to Blue Range's books and records for information, but had its requests denied. Nevertheless, Big Bear pursued the takeover in the absence of information it knew would have been prudent to obtain. It also actively embraced its shareholder status despite the allegations of misrepresentation, putting Blue Range under the *CCAA* in an attempt to preserve its equity value and, in the result, holding Blue Range's creditors at bay and yet it was also attempting to recover its alleged share exchange loss through the claims approval process and rank with unsecured creditors on its claim.

The Court concluded that fairness dictated that Big Bear's claims should be subordinated; and held that if Big Bear's claim was allowed to rank equally with unsecured creditors, it would open the door in many insolvency proceedings for aggrieved shareholders to claim misrepresentation or fraud.[84] It observed that there may be many situations where there should have been better disclosure of the corporation's declining fortunes, as no one would deliberately invest in a corporation that has become insolvent.[85] The Court in *Blue Range* also observed that despite the differences that may exist between Canadian and U.S. insolvency law in this area, assessment of the fairness of a proposed plan by U.S. courts was persuasive for its reasoning based on equitable principles.[86] The Court acknowledged that caution was to be used in following the approach of U.S. courts to ensure that the principles underlying such approach do not arise from differences between U.S. and Canadian law; however, it found U.S. judges persuasive in their policy reasons for subordinating defrauded shareholder claims to those of ordinary creditors as they are rooted in principles of equity similar to the equitable principles used by Canadian courts.[87] The Court quoted from the U.S. *Newton National Bank* judgment, which held that: "when a corporation becomes bankrupt, the temptation to lay aside the garb of a stockholder, on

82. Ibid. at para. 17, citing *Re Central Capital Corp.* (1996), 132 D.L.R. (4th) 223 (Ont. C.A.) at page 245; *Canada Deposit Insurance Corp. vs. Canadian Commercial Bank* (1992), 97 D.L.R. (4th) 385 (S.C.C.) at pages 402 and 408

83. Ibid. at para. 29.

84. Ibid. at para. 45.

85. Ibid. The Court held that although the recognition that this may greatly complicate the process of adjudicating claims under the *CCAA* is not of itself sufficient to subordinate Big Bear's claim, it is a factor that may be taken into account.

86. Ibid. at para. 44.

87. Ibid. at para. 54.

one pretense or another, and to assume the role of creditor, is very strong, and all attempts of that kind should be viewed with suspicion".[88]

The Court concluded, based on its characterization of the claim, the equitable principles and considerations set out in the U.S. cases, the general expectations of creditors and shareholders with respect to priority and assumption of risk, and the basic equitable principle that claims of defrauded shareholders should rank after the claims of ordinary creditors in a situation where there are inadequate assets to satisfy all claims that Big Bear must rank after the unsecured creditors of Blue Range in respect to the alleged share exchange loss, the claim for transaction costs and the claim for cash share purchase damages.[89]

In sum, the Court held that it was clear under corporate law and common law principles that shareholders are not entitled to share in the assets of the debtor corporation until ordinary creditors have been paid in full, as creditors assess risk and price their loans on the basis of that priority and shareholders invest with the knowledge that they are taking the risk of business failure.[90] It was also concerned about the administrative difficulties that would be imposed on insolvency professional in trying to process claims. The Court left open the question of whether there were instances in which the fact that a party with a claim in tort or debt is a shareholder is coincidental and incidental, but this appears to be a narrow exception, the Court giving the example of a shareholder who slips and falls outside of the corporate office who may have potential claims in negligence.

The reasoning in *Blue Range* was subsequently endorsed by another judge of the Alberta Court of Queen's Bench in *National Bank of Canada* v. *Merit Energy Ltd.*, where the Court held that the claims of shareholders arising from alleged misrepresentation in a prospectus were subordinate to the claims of the debtor company's unsecured creditors as they were in substance shareholder claims for return of equity investment.[91] The Court held that while the shareholders paid a premium for the shares, the debt features associated with an indemnity from the debtor did not transform that part of the relationship from a shareholder to a creditor relationship. However, the Court also held that the indemnity claims of the underwriters, directors, and officers were not subordinate to the claims of unsecured creditors because they were claims that were provable in bankruptcy, as they were based on contractual, legal, and equitable duties owed by the debtor to the underwriters. Unlike shareholders who assume the risk of insolvency, the underwriters bargained as a creditor, and to subordinate their claims would fundamentally change the underlying business relationship between underwriters and issuers.[92] The Court further held that equitable subordination did not apply, as there was no evidence of inequitable conduct on the part of the underwriters, no corresponding injury to other creditors, or an enhancement of

88. Ibid. at 47, citing *Newton National Bank* vs. *Newbegin* 74 F. 135 (8th Cir., 1896) at 140.
89. Ibid. at para. 57.
90. Re Blue Range Resource Corp. (2000) 15 C.B.R. (4th) 169 (Alta Q.B.), at 17.
91. National Bank of Canada vs. *Merit Energy Ltd.* 2001 CarswellAlta 913 (Alta. Q.B.).
92. Ibid. at para. 64.

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the underwriters' position.[93] Hence, these claims ranked with other unsecured creditors.[94]

Hence, while there appear to be only two reported cases in Canada, the judgments that have been rendered have used equitable principles and corporate law principles to subordinate shareholder claims in insolvency proceedings without really detailed consideration of securities law violations or the intersection of securities laws and insolvency law and their respective public policy goals. For example, there are a number of differences in Canadian and U.S. securities law that may govern the extent to which investors will have remedies, such as fraud on the market provisions in the U.S. that allow investors to more easily establish claims than a scheme that requires strict causation to be established.[95] Moreover, securities litigation has generally been less frequent in Canada than the U.S. as Canada has a "cost follows result" rule that is generally applied, which acts as a restraint on bringing frivolous or unmeritorious actions. To date there has not been an appellate judgment in Canada on the treatment of claims arising out of securities law violations.

In fairness to the Canadian courts, it is not evident on the face of the first judgments regarding subordination of claims arising from the alleged misconduct of the debtor or its officers that the courts were provided with comprehensive public policy arguments as to why treatment of claims for statutory violations may be deserving of different considerations, as was provided to the High Court of Australia in *Sons of Gwalia*, discussed in Part E below.[96] Moreover, *Blue Range* appears to be highly fact driven, with the court addressing particular conduct of a shareholder in its takeover bid and hence may not offer real guidance to parties. Arguably, the corporate law provisions for plans of reorganization provide a means of dealing with the equity itself; however, they do not provide a means of dealing with damage claims arising from equity rights and this is an area in which the courts need to exercise their gap-filling authority to make determinations as to priority of claims.

While these two judgments suggest fairly rigid subordination of claims for damages arising out of alleged violations of securities law, there are two Canadian judgments that hint at a different approach, but do not determine the question. Although of limited assistance because it was an uncontested endorsement order, Justice Farley of the Ontario Superior Court dealt with the subordination question on an unopposed motion.[97] The Court, in approving a motion for Bell Canada International as a continuing corporation to redeem and pay out on maturity of high yield notes, addressed a pending shareholder action. It held that even if leave was granted to the shareholders by the Supreme Court of Canada and there was subsequent success at trial, the Court did "not see any reasonable justification for any award that might then be granted not being treated as subordinate to the obligations under the

93. The Court left open the question of whether the doctrine applies in Canada, finding that even if it does exist, it was not applicable in the circumstances, *ibid.*

94. Ibid. at para. 68.

95. Arguably, however, recent changes to securities law in Canada have moved Canadian securities law closer to the U.S. model.

96. Sons of Gwalia Ltd vs. Margaretic (2007) HCA 1.

97. In the Matter of Bell Canada International Inc., Court File No. 02CL-4553 (14 September 2004) (Ont. S.C.J. (Commercial List)), Endorsement of Farley, J.

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High Yield Notes".[98] The Court held that "any exercise in logic or practicality would lead to the reasonable conclusion that such an award relating to secondary market activity (i.e., it not being a section 130 *Securities Act* claim as to a primary issue) should be treated as continuing in priority terms to be the equivalent of equity (and not as debt, whether or not it be subordinated or *pari passu*)".[99] Section 130 refers to liability for misrepresentation in an offering memorandum.[100] Hence, the Court left open the question of whether a claim arising from primary market securities law violations would be treated differently than secondary market purchases.

A second Canadian judgment implies, without deciding the issue, that claims for damages arising out of securities law violations may be creditor claims. *Menegon v. Philip Services Corp.* involved a motion by Philip Services for authorization to enter into a proposed settlement under the Ontario *Class Proceeding Act*.[101] Philip Services Corp. was the parent company of a network of 200 directly and indirectly owned subsidiaries in Canada, the United States and elsewhere.[102] Various class actions alleged that Philip's financial disclosure contained material misstatements in violation of United States securities laws.[103] Menegon commenced a class proceeding in Ontario for misrepresentation and rescission relating to his purchase of Philip shares, alleging violations of Canadian securities law. Philip filed for bankruptcy protection in the United States and for protection in Canada under the *CCAA*.

The shareholder class actions in both the U.S. and Canada were based on the same non-disclosure. In the U.S., the class action claims were clearly subordinated and had no voting rights because of s. 510(b) of the *Bankruptcy Code*, but in Canada, there was no equivalent provision. In addition, the auditors and underwriters had claims for indemnification against the company as they were co-defendants in the class actions and claimed that they also had been misled. The auditors had prepared consolidated audited financial statements of the Canadian parent and its many U.S. and Canadian subsidiaries. Under the U.S. *Bankruptcy Code*, these claims would be subordinated and would have no voting rights. In Canada, there was no equivalent rule. The problem was that there were identical claims against one company that were entitled to different treatment on different sides of the border.

Given the nature and quantum of the claims, a resolution of the class action proceedings was an essential element of any successful restructuring and the parties entered into a memorandum of understanding that outlined a proposed settlement

98. Ibid. at para. 3.

99. Ibid.

100. Section 130 of the Ontario *Securities Act*, R.S.O. 1990, c. S. 5, as amended specifies: "130.1 (1) Where an offering memorandum contains a misrepresentation, a purchaser who purchases a security offered by the offering memorandum during the period of distribution has, without regard to whether the purchaser relied on the misrepresentation, the following rights: (1) The purchaser has a right of action for damages against the issuer and a selling security holder on whose behalf the distribution is made. (2) If the purchaser purchased the security from a person or company referred to in paragraph 1, the purchaser may elect to exercise a right of rescission against the person or company. If the purchaser exercises this right, the purchaser ceases to have a right of action for damages against the person or company".

101. Menegon vs. Philip Services Corp. (1999) O.J. No. 4080 (Ont. S.C.J. (Commercial List)).

102. Ibid. at para. 2.

103. The class action proceedings were an action for misrepresentation, negligent misrepresentation and rescission relating to the purchase of shares. The actions were consolidated and ultimately dismissed, though an appeal was pending at the time of this judgment.

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between Philip and the U.S. and Canadian class action proceedings.[104] Under the plan each class of stakeholders in the group of companies with similar characteristics were to be treated similarly whether they are located in the U.S. or Canada.[105] Hence, the plan proposed that the claims of Philip's creditors, whether Canadian or U.S., were to be dealt with under the U.S. Plan and governed by Chapter 11 of the U.S. *Bankruptcy Code*, including the claims of the auditor, the underwriters, and officers and directors for contribution and indemnity in relation to the U.S. and Canadian class proceedings. The Court held that class proceedings were certified as against Philip for settlement purposes only.

The Court held that it was premature to approve a settlement of the U.S. and Canadian class action proceedings at that stage of the restructuring process.[106] The Court held that the class action plaintiffs and the co-defendants are all unsecured claimants of Philip:

> The class action plaintiffs and the co-defendants are all unsecured claimants of Philip in the restructuring process—the claim of the co-defendants for contribution and indemnity against Philip and its former officers and directors arise out of the same "nucleus of operative facts" as the claims of the class action plaintiffs against Philip; and one follows from the other. It has frequently been noted that the full name of the *CCAA* is "An Act to facilitate compromises and arrangements between companies and their creditors". In the bare-knuckled ring of commercial restructuring negotiations, this cannot be accomplished if one group of unsecured claimants is given an unwarranted advantage over another.[107]

The Court was not persuaded by submissions that if the proposed settlement was not approved, the U.S. and Canadian class action plaintiffs would get nothing because Philip would be liquidated.[108] The Court held that where the proposed structure of the reorganization affects the substantive rights of claimants in a fashion that treats them differently than they would otherwise be treated under Canadian law, and where the effect of that treatment is to place the claimants in a position where their ability to engage in full and complete negotiations with the debtor company are impaired, there is cause for concern on the part of the court; hence the loss of the right to vote in the Canadian plan was problematic.[109]

The Court held that while the fact that treatment of claims under U.S. bankruptcy law would be considerably less favorable than their treatment under Canadian law was not determinative, it was a factor for consideration when taken in conjunction with the loss of voting rights in the Canadian plan.[110] It held that for purposes of the *CCAA*, the claim of an unsecured creditor includes a claim in respect of any indebtedness, obligation of liability that would be a claim provable in bankruptcy, and therefore included a contingent claim for unliquidated damages.[111] Thus, the claimants were all entitled to assert claims in the *CCAA* proceedings. The Court held that the extension of comity as between courts in cross-border insolvency situations

104. Menegon vs. Philip Services Corp., supra, note 101 at para. 13.
105. Ibid. at para. 17.
106. Ibid. at para. 29.
107. Ibid. at para. 29.
108. Ibid. at para. 32.
109. Ibid. at paragraphs 35–36.
110. Ibid. at para. 39.
111. Ibid. at para. 40.

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are matters of great importance in order to facilitate the orderly implementation of insolvency arrangements. However, it held that comity and international cooperation do not mean that one court must cede its authority and jurisdiction over its own process or over the application of the substantive laws of its own jurisdiction.[112] The Court concluded that the Canadian plan was flawed because it sought to exclude Canadian claimants from participation in its process by providing that their claims against Philip were to be governed by the U.S. proceedings while at the same time seeking to bind them to the provisions of the Canadian plan, all without affording those claimants any right to vote.[113]

The Philips judgment indicates that the court viewed the claims for damages arising out of securities law violations as unsecured claims and it expressed concern about a proposed settlement that compromised the right of those claimants to vote on a Canadian *CCAA* plan, although the court did not have to make a definitive determination on the ranking of the claims.[114] The case also illustrates that it would be helpful to have coordination of Canadian and U.S. law on the issue of treatment of equity claims as a means of facilitating the reorganization of corporate groups. Almost all Canadian public companies have a cross-border aspect to their business, and when a large company and its subsidiaries are in concurrent *CCAA* and Chapter 11 proceedings, often the restructuring plan involves restructuring the company and its subsidiaries as a whole. However, if the same type of claim has a different priority and rights in one country than the other, this can be very difficult, and hence requires further public policy consideration.

Subsequent to all of these Canadian judgments, Ontario and Alberta, the provinces in which the above cases were decided, have enacted civil liability regimes for secondary market disclosure. To date, there have been no cases that deal with the intersection of these securities law remedies and remedies under insolvency legislation. It does raise the public policy question of whether there should be a difference in treatment of claims arising from the primary or secondary market. In the former case, the company treasury benefits or the officers personally benefit through resultant bonus compensation, so there may be validity in considering a claim for damages arising out of a prospectus misrepresentation as a creditor claim. The purchaser of the equity would not become a shareholder in respect of that investment but for the company misrepresenting its financial status or prospects in the prospectus. The claimant may or may not be an existing investor in the firm. With respect to secondary market purchases, there is no direct cash to the company treasury from the misrepresentation or other misconduct, and other market players may benefit to the extent of the detriment. While the company benefits indirectly from the misconduct

112. Ibid. at para. 48. Section 18.6(5) of the *CCAA* provides that nothing requires the Court to make any order that is not in compliance with the laws of Canada or to enforce any order made by a foreign court.

113. Ibid. at paragraphs 49, 55. The question of approval of the Settlement, in its present form or some other form was adjourned to a date to be fixed which is more contemporaneous with the sanctioning hearing. Ultimately, the case was resolved by having a reorganization plan under Chapter 11 and a receivership in Canada.

114. In *Laidlaw*, the same problem arose. The jurisdictional issue was solved by having the Canadian proceedings dealt with as ancillary proceedings to the Chapter 11 filing.

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violating securities law in the form of a better credit rating that arises from the market price, this may not be a sufficient reason to treat such claims as debt claims in that company's insolvency proceeding. These differences merit further study.

In Canada, there is now proposed statutory language that will codify subordination of equity claims, as discussed in the following part.

D. Proposed statutory language in Canada to subordinate equity claims

While common law and corporate law principles continue to govern the treatment of equity claims in insolvency, in Canada there is proposed statutory language that will codify subordination of equity claims pursuant to two sets of proposed statutory amendments to the *BIA* and the *CCAA* in 2005 and 2007.[115]

In Canada, the Senate Committee on Banking trade and Commerce in 2003 identified the uncertainty as to the treatment of shareholders' claims in insolvency, given the lack of express statutory language; its view was that "Canadian insolvency law does not subordinate shareholder or equity damage claims", although the basis of that view is unclear in the report.[116] The Senate Committee observed that:

> In view of recent corporate scandals in North America, the Committee believes that the issue of equity claims must be addressed in insolvency legislation. In our view, the law must recognize the facts in insolvency proceedings: since holders of equity have necessarily accepted—through their acceptance of equity rather than debt—that their claims will have a lower priority than claims for debt, they must step aside in a bankruptcy proceeding. Consequently, their claims should be afforded lower ranking than secured and unsecured creditors, and the law—in the interests of fairness and predictability—should reflect both this lower priority for holders of equity and the notion that they will not participate in a restructuring or recover anything until all other creditors have been paid in full. From this perspective, the Committee recommends that: the *Bankruptcy and Insolvency Act* be amended to provide that the claim of a seller or purchaser of equity securities, seeking damages or rescission in connection with the transaction, be subordinated to the claims of ordinary creditors. Moreover, these claims should not

115. An Act to Establish the Wage Earner Protection Program Act, to amend the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act and to make consequential amendments to other Acts, S.C. 2005, Chapter 47, Royal Assent 25 November 2005, not yet proclaimed in force as of 14 June 2007 (Chapter 47). At the time of enactment, all parties agreed that the statute would not be proclaimed in force until the Senate had the opportunity to hold further hearings and make amendments. Further amendments were introduced under Bill C-52 *An Act to implement certain provisions of the budget tabled in Parliament on 19 March 2007*, Royal Assent 22 June 2007, Chapter 29 Statutes of Canada (amending the provisions for eligible financial contracts); and Bill C-62, *An Act to amend the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act, the Wage Earner Protection Program Act and chapter 47 of the Statutes of Canada, 2005*, third reading 14 June 2007, pending before the Canadian Senate as of 14 June 2007 as this paper goes to press.

116. Standing Senate Committee on Banking Trade and Commerce, *Debtors and Creditors Sharing the Burden*, 2003 at 159.

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participate in the proceeds of a restructuring or bankruptcy until other creditors of the debtor have been paid in full.[117]

Several years later, such amendments are still pending.[118] Aside from the Senate Committee report, however, there has been remarkably little public policy debate in respect of whether there is a need to codify the status of securities claims under Canada's insolvency legislation, notwithstanding that amendments pending will subordinate all equity claims. The Joint Task Force on Business Law Insolvency Reform, a task force of two professional organizations, The Insolvency Institute of Canada and the Canadian Association of Insolvency and Restructuring Professionals, made strong policy submissions in support of subordination language.[119] Other than this submission, there is little evidence of public policy debate, particularly in respect of claims arising from securities law violations.

One factor that may be driving the proposed amendments is pressure to align the Canadian provisions with those in the U.S. The above discussion of the Philip case highlights the issue. Some insolvency cases in which debtor corporations were registered in Canada had their claims processed in U.S. proceedings, arguably because creditors wanted the higher degree of certainty that the U.S. strict subordination regime offered.[120] There had been some concern expressed by creditors about the different statutory treatment in the two jurisdictions, one codified and the other not, although as noted above, the only reported cases in Canada gave the identical treatment to equity claims as under the highly codified U.S. *Bankruptcy Code*. Once the Canadian amendments are enacted, such cross-border cases will have to comply with center of main interest tests under Chapter 15 of the U.S. *Bankruptcy Code* and the proposed new cross-border provisions of the Canadian *BIA* and *CCAA*, making venue choice more transparent and predictable and arguably less amenable to forum shopping. However, if there is a major substantive difference between Canadian and U.S. treatment of claims for damages, there will be a continuing incentive for debtors to forum shop and argue that the center of main interests of a Canadian parent company or a Canadian subsidiary is in the U.S. when it has cross-border issues of this type.

If the proposed amendments are enacted, the *BIA* will specify that a party is not entitled to a dividend in respect of an equity claim until all claims that are not equity claims have been satisfied.[121] The statute will define equity interest and equity claims for the first time.[122]

117. Ibid. at 159.

118. Although the Chapter 47 amendments were enacted, they were not proclaimed in force on the basis that all parties agreed the statute would go to the Senate for public hearings and possible amendment. There was a hiatus of a year and a half because of the minority federal government and the need for all parties agreement on the legislative agenda. Instead, the Government introduced a further amending Bill C-62, *supra*, note 115, and that Bill received third reading in the House of Commons in early June 2007 and is likely to be scheduled for Senate hearings in the fall of 2007.

119. Joint Task Force on Business Insolvency Law Reform, *Final Report*, 2002 at 32.

120. The *Laidlaw* and *Loewen* proceedings are arguably examples of this, although each had extensive operations in the U.S. and hence numerous claims were located there.

121. Bill C-62, *supra*, note 115, proposed s. 140.1, *BIA*.

122. Bill C-62, *ibid.*, proposed s. 2, *BIA*.

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> "equity interest" means (a) in the case of a corporation other than an income trust, a share in the corporation—or a warrant or option or another right to acquire a share in the corporation—other than one that is derived from a convertible debt, and (b) in the case of an income trust, a unit in the income trust—or a warrant or option or another right to acquire a unit in the income thrust—other than one that is derived from a convertible debt.
>
> "equity claim" means a claim that is in respect of an equity interest, including a claim for, among others, (a) a dividend or similar payment, (b) a return of capital, (c) a redemption or retraction obligation, (d) a monetary loss resulting from the ownership, purchase or sale of an equity interest or from the rescission, or, in Québec, the annulment, of a purchase or sale of an equity interest, or (e) contribution or indemnity in respect of a claim referred to in any of paragraphs (a) to (d).[123]

Hence, the proposed definition clearly includes claims for losses arising out of purchase or sale of equity investments, which will be considered equity claims and not a debt or liability for purposes of insolvency proceedings; and the proposed statutory language makes no distinction for claims arising out of securities law violations.

In addition, provisions of the *BIA* that currently specify that debts not discharged in bankruptcy for public policy reasons include fraudulent misrepresentation, will now be amended to specify that "any debt or liability resulting from obtaining property or services by false pretences or fraudulent misrepresentation, other than a debt or liability that arises from an equity claim" is not discharged.[124] The policy rationale for the proposed change is that investors willingly engage in taking risk of loss or profit in making equity investments, and that although investors have a right of action against the company where they are fraudulently misled into investing in a business, when a firm is financially distressed, shareholders should be placed at the bottom of the priority of claims.[125]

Under the proposed Canadian statutory reform, no proposal under the *BIA* or plan of compromise or arrangement under the *CCAA* that provides for the payment of an equity claim is to be approved by the court unless the proposal or plan provides that all claims that are not equity claims are to be paid in full before the equity claim is to be paid.[126] This language may be too rigid in that in some cases there may be claims for damages from securities law violations and other creditors may decide that it is helpful to place some value on the table in order to reach agreement on a restructuring plan or because there is goodwill or other reputational reasons to recognize and value such claims. The language as currently proposed would prevent giving such claimants any remedy where other creditors are not paid in full and thus may prevent a positive outcome in some circumstances.

A statutory amendment that specifies "unless the court determines that it is 'fair and equitable' or 'fair and reasonable' to order otherwise", would grant the court authority

123. Bill C-62, *ibid.*, proposed s. 2, *BIA* and proposed s. 2, *CCAA*.
124. Bill C-62, *ibid.*, proposed s. 178(1)(e) *BIA*.
125. Government Briefing Book, Chapter 47 amendments at bill clause no. 37.
126. Bill C-62, *supra*, note 115, proposed s. 60(1.7), *BIA* and proposed s. 6(8), *CCAA*.

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to exercise its discretion in particular circumstances based on the equities in the case. It would allow the court to approve a remedy in cases where damages are sought for egregious conduct on the part of the debtor corporation and its officers. The other option would be to remove damage claims arising out of securities law violations from the above proposed definition of equity claim because, arguably, such claims are not equity claims. The proposed Canadian legislation as currently framed fails to recognize that claims for damages arising out of deception or statutory violations are more similar to claims by creditors for breach of contracts or commercial arrangements than they are to ordinary claims by shareholders to the residual equity in the firm.

In restructuring proceedings, the proposed statutory language specifies that creditors having equity claims are to be in the same class of creditors in relation to those claims, unless the court orders otherwise, but may not vote at any meeting, unless the court orders otherwise.[127] This authority codifies current practice where courts have allowed equity claimants to vote where there is still equity remaining in the debtor corporation. The public policy objective of the proposed amendments is to reduce the power of equity claimants, who might otherwise control the voting where they have substantial claims, and thus avoid any ability to defeat a restructuring plan that has the requisite support of creditors.[128] The language proposed in the 2007 amendments tempered an earlier proposed complete prohibition on voting to add the phrase "unless the court orders otherwise". However, this authority will be of limited assistance to claimants arising out of securities law violations unless the subordination provision in a restructuring is also amended as discussed in the previous paragraph.

The proposed amendments also specify that a plan of compromise or arrangement may not deal with a claim that relates to any debt or liability resulting from obtaining property or services by false pretenses or fraudulent misrepresentation unless the creditor in relation to that debt has voted for the compromise, other than a debt or liability that arises from an equity claim.[129] Thus, a debtor corporation will need the consent of creditors to compromise such claims but will not require the consent of equity claimants for the same liability.

The amendments also specify that the stay order in a restructuring proceeding will not affect the rights of a regulatory body with respect to any investigation in respect of the company or any action, suit or proceeding to be taken by it against the company, except when it is seeking to enforce any of its rights as a secured creditor or an unsecured creditor.[130] There is an exception where the court determines that a viable compromise or arrangement could not be made in respect of the company if that subsection were to apply and where it is not contrary to the public interest that the regulatory body be affected by the stay order.[131]

The proposed changes were passed by the House of Commons and sent to the Canadian Senate in June 2007 and may come into force later this year, depending

127. Bill C-62, *ibid.*, proposed s. 54.1, *BIA* and s. 22.1, *CCAA*.
128. Government Briefing Book, Chapter 47 amendments at bill clause no. 37.
129. Bill C-62, *supra*, note 115, proposed s. 19(2), *CCAA*.
130. Bill C-62, *ibid.*, proposed s. 69.6, *BIA* and proposed s. 11.1 (1), *CCAA*.
131. Bill C-62, *ibid.*, proposed s. 11.1, *CCAA* and s. 69.6, *BIA*.

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upon whether or not Canada faces a federal election. During the legislative process, there was very little policy debate as to whether adopting the U.S. approach to equity claims was preferable to one that has distinguished between ordinary equity claims and those claims arising out of corporate officers' violations of corporate or securities statutes. In part this may be a function of the highly integrated nature of Canadian and U.S. capital markets and the pressure to align both securities and insolvency systems to a certain extent. However, there has not been public debate in respect of whether there are different policy implications given that debtors can enter Chapter 11 proceedings in the U.S. where they are not insolvent, whereas in Canada, insolvency is a pre-requisite to access to proceedings.

Arguably, the lack of policy debate is also a function of there not being an active plaintiff's bar in Canada yet, given the very recent nature of civil remedies, which might have at least raised the public policy issue of whether claims arising out of egregious corporate conduct ought to be treated differently than ordinary business risk. There may also be a cultural difference, in that Canadians generally do not believe that they are as vulnerable to massive corporate fraud as the U.S. is, although cases such as Bre-X are evidence that securities law fraud can occur in Canada. A positive aspect of the proposed statutory language is that it focuses on the nature of the claim and not the claimant, in keeping with jurisprudential treatment of claims generally and the rationale for distinguishing equity claims from debt claims.

Hence the proposed statutory language more closely resembles that in the U.S. than in the U.K. or Australia, which are discussed below. The policy rationale is that investors willingly engage in taking risk of loss or profit in making equity investments, and that although investors have a right of action against the company where they are fraudulently misled into investing in a business, when a firm is financially distressed, equity claimants should be placed at the bottom of the priority of claims.[132]

At the same time as Canada is considering insolvency law reform, new statutory civil remedies for securities law violations have been introduced. Two jurisdictions with more than 85% of the capital market activity in Canada, Ontario and Alberta, recently granted securities holders the right to bring civil suits for misrepresentation; Saskatchewan has followed suit effective 2008, with British Columbia likely to follow.[133] The provisions are aimed at giving meaningful remedies to investors where corporate officers act in violation of continuous disclosure requirements. Since Canadian securities law is premised on disclosure and transparency, the new provisions are an important new tool to ensure the integrity of the system. These provisions are aimed at overcoming common law barriers to remedies by adding a deemed reliance provision such that causation need not be proven. While it is too early to tell what the effect of such provisions will be, where the impugned companies are

132. Chapter 47 Government Briefing Book, Chapter 47 amendments at bill clause no. 37.

133. See for example, the Ontario *Securities Act, supra*, note 100, at Part XXIII.1, which provides for civil liability for secondary market disclosure, and creates a right of action for damages where an issuer fails to make a timely disclosure of a material change or where there is an uncorrected misrepresentation relating to the affairs of the issuer.

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insolvent, the new remedies will be largely ineffective, given the current proposed amendments to the *BIA* and *CCAA*.

There is a further issue of the timeliness of the insolvency process, which in Canada is conducted on a "real-time basis" and the implications for resolving securities law claims or allowing contingent claimants to control the process. Equally, however, the subordination of equity claims, as currently defined in the proposed legislation, may encourage debtor corporations to enter restructuring proceedings in order to subordinate claims, on the basis that if the claims were realized, the company would be insolvent within the meaning of Canadian insolvency legislation. Recent caselaw in Canada has held that "insolvent" should be given an expanded meaning under the *CCAA* in order to give effect to the rehabilitative goal of the statute; and that a court should determine whether there is a reasonably foreseeable expectation at the time of filing that there is a looming liquidity condition or crisis that will result in the applicant running out of money to pay its debts as they generally become due in the future without the benefit of the stay and ancillary protection.[134] This broader definition has facilitated going concern restructurings but may also create inappropriate incentives when coupled with the proposed provisions that subordinate all equity claims in a *CCAA* restructuring proceeding. If the securities claims or other equity-related claims against a debtor are so large they render the debtor insolvent, there is nothing inappropriate about entering restructuring proceedings to deal with the claims and to devise a going forward business strategy. However, if the subordination of claims might encourage tactics where a filing is done as a means to wipe out equity claims without a vote and without compensation, the proposed legislative amendments may or may not provide a means to deal with the issue. If there is a reasonable argument that there is net value in the business after other claims but before the equity claim, the court could decide to exercise its power to allow the holders of the equity claim to vote, providing claimants with leverage in the Canadian system, where there is no cram-down.

In sum, Canada's proposed statutory regime for the subordination of equity claims will make it one of the strictest in the world, not tempered by other legislation that will allow investors to realize at least some of their claims arising from harms due to the misconduct of corporate officers. Such changes have not received full public policy discussion in Canada, and appear aimed at aligning Canada's insolvency regime with the U.S. However, Canada does not have the mechanisms and resources afforded to U.S. securities regulators to provide remedies to harmed equity investors and that allow regulators to serve a gatekeeping function such that insolvency proceedings can continue to provide an expeditious resolution to the firm's financial distress. Some provinces have enacted provisions allowing for a forfeiture of funds and some restitution to investors, but given that Canada is a federal regime, provincial securities law remedies come up against federal paramountcy concerns even if

134. Re Stelco Inc. (2004), 2004 CarswellOnt 1211, 48 C.B.R. (4th) 299 (Ont. S.C.J. [Commercial List]), leave to appeal to C.A. refused (2004), 2004 CarswellOnt 2936 (C.A.).

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they were strengthened to include fair funds type of provisions with enforcement teeth behind them.[135]

In contrast to the Canadian approach, the courts in the U.K. and Australian have tried to reconcile the claims made under securities law and insolvency law schemes.

E. Distinguishing the type of shareholder claims and consequences for subordination—U.K. and Australia

In the U.K., member (shareholder) claims are generally subordinated in insolvency proceedings, based on the same principles as articulated above. In the case of misconduct under securities laws, the House of Lords has adopted a more purposive approach to reconciling securities claims and insolvency priorities.

Section 74(2)(f) of the U.K. *Insolvency Act 1986* specifies that a "sum due to any member of the company, in his [her] character of a member, by way of dividends, profits or otherwise is not deemed to be a debt of the company, payable to that member in a case of competition between himself [herself] and any other creditor not a member of the company, but any such sum may be taken into account for the purpose of the final adjustment of the rights of the contributories among themselves".[136] The U.K. *Act* also specifies that a person is not disbarred from obtaining damages or other compensation from a company by reason only of holding shares in the company and any right to subscribe for shares or to be included in the company's register in respect of shares.[137] The specific language has given rise to the question of whether a claim by a member arising out of misconduct by the debtor corporation or its officers should be treated as a claim "in his character of a member" and, therefore, subordinated, or should be treated as a claim in his or her character as a tort victim, not as "a member", and therefore not subordinated.

In *Soden v. British & Commonwealth Holdings Plc.*, a successful takeover bidder, British & Commonwealth Holdings ("B&C") had purchased the whole of the share capital of the target company for £434 million and sought damages for negligent misrepresentation against the target company when the latter's financial distress became known after the completion of the takeover.[138] The target company went into administration and the court approved a scheme of arrangement to which the bidder, B&C was not a party. The action for damages had not come to trial and the Administrator sought direction on whether B&C's action and another action for third party contribution, if successful, would be subordinated to the claims of other creditors. The critical question for the House of Lords was whether damages ordered for negligent misrepresentation would constitute "a sum due to a member in its character of a member".[139] The House of Lords held that s. 74(2)(f) requires a distinction to be

135. See for example, the B.C. *Civil Forfeiture Act*, which came into force on April 20, 2006. Pursuant to the Act, the Province can apply to the Supreme Court of British Columbia to seize and sell assets acquired through unlawful activity. The *Act* also allows disposal of forfeited proceeds to eligible victims.

136. Section 74(2)(f), U.K. *Insolvency Act 1986*. While member refers to equity investors under U.K. legislation, this paper will refer to members and shareholders interchangeably for the remainder of the paper.

137. Section 111A, U.K. *Insolvency Act 1986*.

138. Soden vs. British & Commonwealth Holdings plc (1998) AC 298 (H.L.). It is unclear from the judgment why the acquiring B&C was not alerted to the corporation's true financial condition.

139. Ibid.

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drawn between sums due to a member in his or her character as a member and sums due to a member otherwise than in his or her character as a member, and that sums due in the character of a member must be sums falling due under and by virtue of the statutory contract between the members and the company pursuant to provisions of the U.K. *Corporations Act*, that is, arise out of a cause of action on the statutory contract.[140] The House of Lords held that the relevant principle is not that "members come last", but rather that the "rights of members as members come last", that is, rights founded on the statutory contract are, as the price of limited liability, subordinated to the rights of creditors. The rationale of the section is to ensure that the rights of members as such do not compete with the rights of the general body of creditors; however, a member having a cause of action independent of the statutory contract is claiming as a creditor and is in no worse position than any other creditor.[141]

The House of Lords further held that the subordination provision, s. 74(2) (f), of the U.K. *Insolvency Act*, did not apply to the takeover bidder because it had purchased shares in the market and not directly from an offering of the debtor company.[142] The House of Lords held that the misrepresentation claims of transferee shareholders should not be subordinated and should rank *pari passu* with unsecured creditors. Hence, the subordination provisions have been interpreted to apply to subscribing shareholders and not transferees.

Essentially, the U.K. court has distinguished the nature of the claim based on the statutory contract of shareholding. It is not a distinction based on fraud versus ordinary business risk associated with equity investments. However, since remedies that arise out of secondary market purchases are remedies for fraud and misrepresentation, the courts are effectively distinguishing on that basis, although only for secondary market purchasers. The reasoning of the House of Lords is the opposite of the reasoning in the Canadian case discussed above.

In Australia, the statutory language is similar to the U.K. Previously, it was generally thought that the subordination provision contained the Australian *Corporations Act, 2001*, which specifies that: "payment of a debt owed by a company to a person in the person's capacity as a member of company, whether by way of dividends, profits or otherwise, is to be postponed until all debts owed to, or claims made by, persons otherwise than as members of the company have been satisfied" meant that shareholders' claims against the debtor company are to be subordinated to the claims of creditors, the Australian courts drawing on early English caselaw.[143] More recently, the Australian courts had adopted a different approach, similar to the reasoning of

140. Ibid. Section 14(1) of the Act specifies that the memorandum and papers bind the company and its members.

141. Ibid.

142. Ibid.

143. In *Webb Distributors (Aust) Pty Ltd. vs. The State of Victoria* (1993) 179 CLR 15; (1993) HCA 61, the Australian High Court held that the *Corporations Act* subordination provisions extended to subordinate the claims of shareholders for misleading and deceptive conduct under the Australian *Trade Practices Act, 1974*. The Court relied on the U.K. House of Lords judgment in *Houldsworth vs. City of Glasgow Bank* (1880) 5 App Cas 317, which held that members cannot claim damages for misrepresentation inducing the purchase of shares while the member continues to be on the share registry; and that members cannot rescind their membership when a company is insolvent. See also *Re Addlestone Linoleum Co.* (1887) 37 Ch D 191. The U.K. corporations statute was amended in 1985 to specify that shareholders were not prohibited from claiming damages only by reason of the fact they continued to be shareholders.

the U.K. House of Lords, in *Soden v. British & Commonwealth Holdings Plc, supra* for treatment of claims arising from statutory violations.[144] However, the High Court of Australia took a different analytical approach in *Sons of Gwalia Ltd. v. Margaretic*, decided in January 2007.[145]

Sons of Gwalia Ltd. v. Margaretic marks a departure from the U.K. reasoning and reflects further development of the Australian court's balancing of different public policy objectives. An investor that purchased shares in Sons of Gwalia Ltd. in the secondary market shortly before the company entered insolvency administration claimed damages pursuant to trade practice and securities legislation on the basis that the company had engaged in misleading and deceptive disclosure in that it failed to disclose material adverse information.[146] Specifically, Margaretic alleged that the company had failed to notify the Australian Stock Exchange that its gold reserves were insufficient to meet its gold delivery contracts and that it could not continue as a going concern, and had misled or deceived Margaretic into buying shares. The shareholder sought to be treated as an unsecured unsubordinated creditor. The court at first instance, the Full Court of the Federal Court and the High Court of Australia all found that the shareholder could be treated as an unsecured creditor because the claim was not "in the person's capacity as a member of the company", although the reasoning of the High Court differs from the lower courts. Given that the shares were purchased in the secondary market, the Federal Court held that his claim under the misleading and deceptive statutory provisions did not arise in his capacity as member, adopting the approach of the U.K. House of Lords.[147]

The High Court of Australia upheld the results, but declined to accept the U.K. reasoning. By a majority of 6-1, the High Court held that a shareholder with a claim under a statute against a company for misleading or deceptive conduct, or for failure to comply with its continuous disclosure obligations could prove in the administration or liquidation of that company in respect of the damages for which the company was liable, and that this applied whether the shareholder acquired the shares by subscription or purchase.[148] This ability to claim applied even though the investor's loss did not crystallize before the administration. The Court held that it would not have applied to equity investors that had sold their shares before the company went into insolvency administration, or who were never on the register, because they invested through nominees, custodians or trusts, as those investors would not have been postponed on any view.[149] The majority of the High Court held that s. 563A of

144. Cadence Asset Management vs. Concept Sports Ltd. (2005) 147 FCR 434.

145. Sons of Gwalia Ltd vs. Margaretic (2007) HCA 1.

146. Ibid. at para. 8. Specifically, he claimed breach of disclosure requirements under securities law continuous disclosure obligations; and misleading or deceptive conduct pursuant to s. 1041H of the *Corporations Act, 2001* (Australia) and s. 12DA of the *Securities and Investments Commission Act, 2001* (Australia); and s. 52 of the *Trade Practices Act,* (Australia).

147. See also *Re Media World Communications* (2005) FCA 51, 52 ACSR 346 (Australia), where the Federal Court of Australia Victoria District adopted the reasoning in *Sons of Gwalia,* but on the facts of that case, it was not a situation where shares were acquired by the shareholder from a third party and the Court held that if the company is in liquidation, the subscribing shareholders' right to be paid a loss from a prospectus purchase (i.e., in their capacity as investors) is postponed under s. 563A, *Corporations Act, 2001* until the claims of persons other than members have been satisfied.

148. Hence, while the Full Federal Court had adopted the reasoning in *Soden* in distinguishing transferees from subscribers, the majority of the High Court did not adopt this analysis.

149. Sons of Gwalia Ltd vs. Margaretic, supra, note 146.

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the *Corporations Act, 2001* did not operate to postpone the debts owed to shareholders with claims against a company for misleading or deceptive conduct. Shareholders with such claims were not owed debts in their capacity as members of the company. Rather, they were seeking to enforce against the company remedies to which they were entitled under various statutes providing protection to investors.

The Chief Justice of the High Court held that the determining factor was that the shareholder's claim was not founded upon any rights he obtained or any obligations he incurred by virtue of his membership of the company.[150] He noted that modern legislation has greatly increased the scope for shareholder claims with more intensive regulation of corporations, breach of which may sound in damages for the protection of members of the investing public.[151] He wrote:

> On the one hand, extending the range of claims by shareholders is likely to be at the expense of ordinary creditors. The specter of insolvency stands behind corporate regulation. Legislation that confers rights of damages upon shareholders necessarily increases the number of potential creditors in a winding-up. Such an increase normally will be at the expense of those who previously would have shared in the available assets. On the other hand, since the need for protection of investors often arises only in the event of insolvency, such protection may be illusory if the claims of those who are given the apparent benefit of the protection are subordinated to the claims of ordinary creditors.[152]

The Court proceeded to distinguish the language under Australian legislation from the subordination language in the U.S. *Bankruptcy Code*. The High Court judgment is significant in that it distinguishes claims arising from deceptive practices from those that arise normally in a shareholder's capacity as shareholder. In this respect, the High Court noted that claims arising under securities, corporate, and trade practices legislation are not restricted to only shareholders and hence do not arise out of the shareholder contract. The judgment is aimed at a balance between securities, corporate, and insolvency law regimes, allowing shareholder claims arising out of securities laws violations essentially to rank with ordinary creditors based on the terms of the applicable Australian statute, which did not contain the U.S. statute's express subordination mandate.[153]

The recent cases in the U.K. and Australia raise some interesting issues in respect of securities claims in insolvency.[154] First, those with claims against the debtor corporation for its misconduct are found to resemble unsecured creditors more closely than equity claims. Arguably, the recognition of these types of claims as creditor claims by the U.K. and Australian courts is based in part on the express statutory language, and in part on the recognition by the courts that it is important to give public policy recognition to the objectives of both securities law and insolvency law in

150. Ibid. All of the Justices wrote a decision.
151. Gleeson, C.J., *ibid.* at para. 17.
152. Ibid. at para. 17.
153. The judgment deals with the status of the claim if it is established; it does not determine the case on its merits.
154. Craig Edwards has suggested that courts in New Zealand are likely to follow the reasoning of the Australian court, although to recover damages from New Zealand's Fair Trading Act, the complainant must show reliance on the misleading conduct and causation, which may be difficult to establish. Craig Edwards, "Headaches for Insolvency Practitioners as a Result of the *Sons of Gwalia* Decision, NZ Insolvency Bulletin, March 2007 at 2.

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order to support fair and efficient capital markets. Another issue is whether recognition of such claims will create particular incentive effects, such as creating incentives to make such claims as a means of being recognized as a creditor in the negotiations for a workout or other outcome of a firm's insolvency.

In the *Sons of Gwalia* case, there are 5304 shareholder claims made in the administration, asserting aggregate damages of Aus $242 million arising from allegations of violations of securities, corporate, and trade practices legislation.[155] The case illustrates that if such claims are to be treated on parity basis with unsecured creditors, there may be huge implications for the pool of assets available to satisfy creditors' claims. Moreover, it raises the question of the timeliness and efficiency of how such claims are to be determined. However, the Australia High Court's reasoning may not create extensive remedies for shareholders and substantial losses for creditors in the amount of assets available to satisfy their claims in many insolvency proceedings. There are hurdles to shareholders proving that the company engaged in prohibited conduct and that the conduct led to his or her loss or damage. The *Sons of Gwalia* case only establishes that a shareholder can bring an action.

There are also hurdles to pursuing shareholder litigation under the English rule of legal costs. In Australia, however, the courts have approved the ability of litigation funding firms to provide funding not only for the prosecution of shareholder claims but also to indemnify the shareholders against an adverse costs order. In a somewhat imperfect fashion, this funding mechanism helps to minimize the pursuit of spurious shareholder claims, on the basis that for-profit litigation funding firms are not likely to pursue shareholder claims unless the funders have concluded that there is a high probability of success on the merits. In the U.K., on the other hand, litigation funding firms have not found favor, which is likely the principal reason why shareholder damages claims are rarely asserted in U.K. insolvencies as a practical matter.

From an administrative perspective, the ability of shareholders to bring claims under insolvency proceedings raises the question of whether there will be higher administration costs as administrators assess whether to admit shareholder claims, and in dealing with challenges to their decisions. Absent a statutory framework that creates a "deemed reliance" on the conduct such that causation need not be proven, the processing of these claims could prove extremely costly and time consuming, both for insolvency administrators and for the claimants, whether they are proceeding by class action or individually. Another issue is how insolvency professionals are going to assess the quantum of the loss and damage, particularly where there are many investors seeking a remedy for the misconduct of the debtor company. Given that these claims are contingent in the sense that while the claim has crystallized at insolvency, the scope of liability and damages has not yet been determined; and given that there are time pressures in insolvency proceedings, a concern is that such claims may detract from developing a viable going forward business plan, particularly where shareholders do not see any upside in compromising their claims in order to facilitate

155. Ferrier Hodgson, *Report to Creditors, Sons of Gwalia*, ACN 008994287 (24 November 2006); http://www.ferrierhodgson.com.au/caseprofiles/details.cfm?objectID=11.

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a restructuring. Moreover, this additional process may affect the timeliness of meeting creditors' claims. Equally, however, the Australian court has sought to strike a balance between two important public policy goals.

Subsequent to the judgment, shareholders of Gwalia were permitted to vote on a proposed sale of the business by the administrators, even though the alleged fraud had not been proven and reliance not yet established, and they were permitted to vote the full amount (Aus $250 million) of their claims, some of which were quite contingent.[156] The proposed sale would yield a dividend to creditors of only 12 cents on the dollar. A group of U.S. creditors holding Aus $300 million in claims proposed a competing bid because they felt the sale price was too low; and their proposal featured the upside potential of an equity distribution.[157] Most of the shareholders were individual investors and voted with the administrators' proposal. However, creditors with claims totaling Aus $600 million voted against the administrators' proposed sale, while only Aus $320 million voted in favor, including the shareholders.[158] Under Australian law, where a vote splits, the administrator casts the deciding ballot and notwithstanding that the majority of claimants by value vote against the sale, the administrator's vote is determinative.[159] The case, while still pending, illustrates how recognition of such claims may affect the outcome of insolvency proceedings, and raises new questions in respect of fairness in the claims valuation and voting process. Here, the process recognizing shareholder claims on a *pari passu* basis worked to advance the insolvency professional's proposed sale, but did so against the express wishes of creditors holding the vast majority of claims by value.

Shortly after the High Court's judgment was rendered, the Australian government directed the Corporations and Markets Advisory Committee to study three issue in respect of equity claims, specifically: (1) should shareholders who acquired shares as a result of misleading conduct by a company prior to its insolvency be able to participate in an insolvency proceeding as an unsecured creditor for any debt that may arise out of that misleading conduct, (2) if so, are there any reforms to the statutory scheme that would facilitate the efficient administration of insolvency proceedings in the presence of such claims, and (3) if not, are there any reforms to the statutory scheme that would better protect shareholders from the risk that they may acquire shares on the basis of misleading information?[160]

From a public policy perspective, one of the most helpful aspects of the *Sons of Gwalia* judgment is that it has assisted in sparking a broader public policy discussion

156. Evan Flaschen, "Australia: The Sins of the Sons (of Gwalia) are Visited on Creditors Yet Again", Bracewell & Giuliani Newsletter, 27 July 2007, http://www.bracewellgiuliani.com/index.cfm/fa/news.advisory.print/item/2108cb12-96f3-40bb-8. Flaschen reports that some of these claims included claims for "lost opportunity damages", such as, if the investor had known of the fraud he or she would have invested in another company and hence the investor lost the amount of profits made by that other company. He reports that shareholders were deemed for voting purposed to hold Aus $250 million of the Aus $1.1 billion of claims eligible to vote.

157. Ibid. at 2.

158. Ibid.

159. This is in contrast to U.S. or Canadian law, whereby a vote by creditors to against the proposed sale would be sufficient to defeat it.

160. Chris Pearce, MP, Parliamentary Secretary to the Treasurer, http://parlsec.treasurer.gov.au/cjp/content/pressreleases/2007/002.asp (February 7, 2007). The committee's deliberations are still pending as this paper goes to press.

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regarding subordination of claims that arise from statutory violations. Such claims are clearly distinguishable from equity claims arising in the course of firm insolvency, for which there is broad global consensus regarding their placement of the hierarchy of satisfaction of claims. Given that securities law and insolvency law regulate different aspects of the provision of capital to business, it is important that there be a balance in how their policy goals and substantive remedies are realized when the two schemes intersect. How they are to be reconciled requires further public policy discussion.

One final aspect of this subordination debate is the treatment of claims where they have elements of equity or options for investment of equity, but are not held by shareholders *per se*, as discussed in the next part.

F. Subordination of stock-based compensation claims

A sub-issue issue that has arisen in the U.S. is the status of stock-based compensation claims where a debtor corporation becomes insolvent. Two recent U.S. appellate cases have addressed the treatment of claims where company executives had stock-price-based unpaid compensation claims, arriving at different results.

In re Med Diversified Inc., the trustee sought a court order subordinating the claim of an executive whose severance package included the corporation agreeing to exchange its stock for stock owned by the departing executive in another company, an exchange that did not occur before the corporation filed for bankruptcy.[161] The Second Circuit Court of Appeals held that the claim was subordinated, and that § 510(b) of the U.S. *Bankruptcy Code* intended to subordinate those claims where the claimant took on the risk and return expectations of an equity investor or seeks to recover a contribution to the equity pool that is presumably relied on by creditors in their lending decisions. The Court held that by trading the relative safety of cash for the upside potential of shareholder status, the executive's potential benefit of being a stockholder was sufficient to subordinate the claim under § 510(b). He had bargained for status as a shareholder rather than a creditor.[162] The Court observed that this reasoning is similar to *Betacom*, in which the court held that there are two main reasons for subordination of a claim pursuant to § 510(b), the dissimilar risk and return expectations of creditors and shareholders; and the reliance of creditors on the equity cushion provided by shareholder investment.[163] In *Med Diversified*, the first policy rationale was found, and the Court held that it was not troubled by the fact that the equity-cushion rationale was not directly applicable.[164]

In contrast, in *re American Wagering Inc.*, the Court of Appeals for the Ninth Circuit held that a financial advisor whose promised compensation for assisting with the

161. In re Med Diversified, Inc. (2006) 461 F. 3d 251 (2nd Cir.).

162. Ibid. at 256. See also *In re Enron Corp.*, 341 B.R. 141, 162-63 (Bankr. S.D.N.Y. 2006), which subordinated the claims arising from ownership of employee stock options, on the basis that the cash value of the options varied with the value of the debtor's stock and to that extent resembled a typical equity interest.

163. American Broadcasting Sys., Inc. vs. Nugent (In re Betacom of Phoenix, Inc.), 240 F.3d 823 (9th Cir. 2001); see also *In re American Wagering Inc.* (2006) 465 F. 3d 1048 (9th Cir.).

164. In re Med Diversified, Inc. (2006) 461 F. 3d 251 (2nd Cir.) at 259.

debtor's initial public offering was to be paid in the form of shares in the debtor company, when he successfully sued for the cash equivalent value of his claim, should not have his claim subordinated under § 510(b).[165] The Court held that he did not sue the debtor as an equity investor seeking monetary damages for fraud or breach of contract; rather, he sued as an agent that did not receive promised compensation under an employment agreement. The Court of Appeals held that the monetary judgment awarded initially, before the bankruptcy, established a fixed pre-petition debt owing the financial advisor as a creditor, and that he was not in the position of risk or return equity investor and hence he should be treated as an ordinary unsecured creditor.[166]

It is unclear that the cases can be reconciled based on the nature of the claim and whether it resembles the risk and returns associated with shareholder investment. Where the claim is clearly a debt, as in a judgment for cash making the claimant a judgment creditor, then the court may not subordinate the claim. That was a key part of the court's reasoning in *re American Wagering Inc.* However, the main rationale in *re Med Diversified Inc.* appears to apply in *re American Wagering Inc.* in that the consultant took the equity risk rather than cash. One question is why the timing of the court's decision should determine whether the party is a creditor or an equity investor. If the claim is subordinated in one instance and not the other, there may be a rush to litigation where claimants seek to protect their interest and outpace the filing of any insolvency proceeding, which in turn may deter these types of compensation arrangements or the settlement of such claims. On the other hand, litigation is slower than a decline into insolvency, and hence this may not ultimately be a material concern.

The debate in various jurisdictions regarding the treatment of claims arising out of securities law violations continues to be unresolved. The next part discusses several policy options that attempt to reconcile the tensions arising out of the conflict in priority of claims under the different public law regimes.

III. Policy Options Regarding the Treatment of Claims Arising Out of Securities Law Violations

While there is a need for greater certainty in respect of how claims for securities law violations are to be treated, the solution is not immediately evident. This part commences a discussion of some of the potential options for dealing with such claims.

In developing a framework that would support the public policy goals of both securities law and insolvency law, one needs to consider the nature of the harms for which damages are sought. For example, fraud is a particularly egregious harm. Misrepresentation, however, can be intentional, with the intent to defraud investors, or it can be a violation based on timeliness of disclosing information to the market.

165. In re American Wagering Inc. (2006) 465 F. 3d 1048 (9th Cir.).

166. For a comment on these cases and on how compensation should be structured, see A. Ostrow and C. Pourakis, "Taking Stock of Unpaid Compensation Claims, How to Avoid Losing Rights Based on Stock Value when the Stock Falls to Zero in Bankruptcy", Stevens & Lee Newsletter (10 January 2007).

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This latter type of misrepresentation is a harder issue in terms of thinking about remedies arising from misconduct. There can be considerable uncertainty in respect of the scope of continuous disclosure requirements, both in terms of content of the disclosure and in the timing of such disclosure such that ephemeral information is not unnecessarily disclosed to the market.[167] While securities law mandates timely disclosure, in practice, there are difficult decisions in respect of what is material or sufficiently crystallized such that it should be disclosed.[168] Thus, another question is just how timely a publicly traded debtor corporation must be in disclosing its financial distress such that shareholders can decide to buy, sell, or hold based on that expectation of decline, and such that their future claims rank equally with unsecured creditors. Moreover, where does business judgment in regard to timing of disclosures and deference to that judgment fit into the overall scheme of how such issues are to be treated? A non-insolvency case on precisely this issue is currently pending before the Supreme Court of Canada.[169]

Whatever policy option is considered, it must be measured against its effect on both debt and equity markets, as it may affect both investor confidence and the price of credit, as well as the transaction costs of both litigation and of valuing claims that arise during insolvency proceedings. The subordination of an equity claim does not facilitate a restructuring unless the issue of voting rights is also addressed, because securities claimants would form a class that could veto a proposed restructuring plan, absent clear statutory language preventing such an outcome.[170] Litigation involving claims of this type is complicated and slow. If there is a class action that hasn't been certified, the case can take a very long time.

It is also important to note that most debtor companies have not engaged in misrepresentation or deceptive conduct, such that their insolvency will give rise to securities law claims. A hallmark of both statutory schemes is transparency, certainty, and efficiency, objectives that should be borne in mind in considering policy options.

One possible policy option is that only new purchasers of securities under either primary offerings or secondary market purchases would have claims arising from securities law violations ranked equally with unsecured creditors, on the basis that the purchaser of an equity investment would not be a shareholder in respect of the investment but for the company misstating its financial status. In support of this option, one could argue that existing shareholders arguably have access to information such that they can be monitoring their risk and making timely decisions to buy more equity, hold or sell their investment. The difficulty with this policy option is that, for the most part, today's shareholders are not insiders; they are a widely dispersed group that does not have the time, resources or capacity to monitor corporate

167. Janis Sarra, 'Modernizing Disclosure in Canadian Securities Law: An Assessment of Recent Developments in Canada and Selected Jurisdictions', Study for the Task Force to Modernize Securities Legislation in Canada (Toronto, IDA, 2006).

168. An example would be early discussions regarding merger.

169. Kerr vs. Danier Leather Inc. 77 O.R. (3d) 321 (Ont. CA), leave to appeal to SCC granted and judgment pending.

170. For example, if another court were to follow the Canadian court judgment in *Blue Range* and decide on equitable principles to subordinate an equity claim behind unsecured creditors, the result would be that the equity claim would get a veto over the restructuring.

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officers. Their decision to hold or sell is based on the disclosures being made by the corporation in any new offerings or under continuous disclosure obligations. While their claims arising from ordinary business risk are those that they have willingly accepted, this approach does not deal with the distinction of remedies for statutory violations.

One difficulty with the company having to pay for the damages under this option as if investors were creditors is that existing equity investors that have been similarly harmed suffer the consequences of both the original harm and then further losses as assets are directed to compensate claimants, assuming that is any equity left at the point of insolvency proceedings. Moreover, if a key objective is deterrence of misconduct, the fact that the assets of the company are used to compensate for damages may not be the optimal approach to deterrence of officers' conduct. This policy option fails to make the distinction between new purchasers purchasing in the secondary market, where the company only indirectly benefits from the misconduct (absent fraud) and new purchasers in the primary market.

The second option is similar to the first, but would rank new purchasers equally with unsecured creditors only where there were violations of primary offering requirements of securities law. This option is premised on the fact that violations of securities law in primary markets offerings results in a benefit accruing directly to the company. Secondary market violations do not result in any money directly to the corporate treasury. Arguably then, investors should seek remedies directly from the corporate officers that engaged in the misconduct, and then those officers could pursue the corporation if indemnity was available for the particular misconduct. This option would assist in maintaining the integrity of primary markets by ensuring that prospectuses are accurate and timely in their disclosures. However, to treat primary market and secondary markets differently where there is a violation of securities law may be difficult to justify on public policy grounds, not withstanding the temptation to try to scope the availability of such remedies during insolvency, given that this distinction is not made outside of insolvency. Moreover, the introduction of short form prospectuses and the seasoned issuers requirements in the U.S., Canada, and other jurisdictions means that the lines between primary and secondary markets is blurring such that the same disclosure information is applied for securities issued and resold, and hence there is a question as to why claims from securities law violations should be distinguished based on primary or secondary markets.[171]

Another option is to grant securities regulators enhanced powers such that disgorgement of funds and penalties paid for misconduct can be directed towards investors harmed by the misconduct of the debtor corporation or its officers, as has occurred in the U.S. While this does not allow equity investors to realize directly on their claims, it does offer some financial relief from the harms caused. In such a model, the securities regulator serves a gatekeeping function that ensures that only meritorious claims are advanced and that securities claims are not inappropriately

171. See the discussion in Sarra, *supra,* note 167 regarding WKSIs in the U.S. and the blurring of primary and secondary market disclosure requirements.

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used by shareholders to leverage their position or their voice and control rights during insolvency proceedings. The difficulty is that securities regulators may determine that the harms caused in a particular case do not merit their resources being directed toward enforcement, leaving those equity investors without a remedy. Moreover, few, if any, jurisdictions have committed the resources and energy to securities enforcement that the U.S. has, and hence such an option in other jurisdictions may be less meaningful or effective.

The fourth option would be to treat all shareholder claims arising out of securities law violations as unsecured creditor claims on the basis that these liabilities are remedies to which investors are entitled under various statutes providing protection to investors. It is unclear that there has been a cogent public policy rationale advanced for the proposition that shareholders and creditors should be treated differently in respect of securities laws violations where neither contracted for fraud risk and frequently neither have the capacity to monitor against such risk. It also seems unclear why jurisdictions are moving on the one hand to enhance the remedies available to securities holders for corporate misconduct and on the other hand proposing that if the conduct is sufficiently egregious that satisfaction of claims makes the company insolvent, then the claims are completely subordinated to other interests in the firm. Parity in treatment of claims arising from statutory violations would remedy this problem.

While such claims under this option may initially be contingent, they arguably crystallize on insolvency and they would have to be provable and quantifiable. There are a number of consequences that would have to be considered in order to design a framework that was expeditious and fair for the valuation and resolution of such claims. In some jurisdictions, for example, there is the issue of causation, which is time-consuming and expensive to determine and which would slow the resolution of securities law claims in insolvency proceedings considerably. Hence, this option could result in insolvency proceedings grinding to a near halt, which in turn may result in value lost for all stakeholders with an interest in the firm. Moreover, claimants seeking remedies may suffer litigation fatigue and loss of even greater resources as they try to establish their claims. Yet the challenges for designing a system for the expeditious determination of claims arising out of securities law violations should not be a bar to recognizing these claims, just as product liability or other tort claims are treated as unsecured claims. It is unclear why damage claims arising from securities law violations should be subordinated when other types of tort claims are not; and this discrepancy in treatment is an issue that needs to be addressed by legislators. Most critically for the resolution of securities law claims within insolvency proceedings is whether there is a mechanism that can determine the validity and value of claims in an expeditious manner that would still allow equity claimants to participate in insolvency proceedings.

The fifth option is of course complete subordination of all claims, as is proposed in Canada and as is the law under the U.S. *Bankruptcy Code*, subject to the *Sarbanes-Oxley Act* fair funds provision as discussed above. While this option has a certain simplicity

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that creditors would find reassuring, it fails to address all the difficulties highlighted throughout this paper.

One of the unknown factors in considering all of these options in respect of Canadian law is that the secondary market civil liability regime is so new that it is difficult to determine how easily it will or will not be to establish damages for violation of securities law requirements. Under the recent Canadian legislation, there is no requirement to establish reliance, but there is a cap on the amount that individuals can be found liable for any failure to disclose or misrepresentation. There is no cap on damages where fraud or intentional or authorizing misrepresentation or failure to disclose is proven.[172] Hence, the deterrence effects of particular options may also be limited. Moreover, as noted earlier, the Supreme Court of Canada has yet to rule on the issue of the amount of deference that will be given to business judgment in the context of complying with securities law disclosure requirements. In this sense, outright fraud is the easier issue to determine, than an issue such as misrepresentation of the issuer's financial situation or its future oriented financial prospects.

These options also reveal that conflation of remedies for deterrence or investor compensation for harms may not always be possible, and thus there are both tensions within securities law and tensions that arise when it intersects with insolvency law.

The next part examines a different aspect of the intersection of securities and insolvency law, specifically, the treatment of claims arising out of the insolvency of securities firms in insolvency. Unlike the subordination debate, the issues here arise in the context of tracing property claims. This framework involves issues quite distinct from the issue of subordination of claims, but it is an important aspect of reconciling the two regimes. Moreover, it raises some of the same questions in respect of whether the scheme adequately addresses the issue of fraud and other securities law violations in the course of insolvency proceedings.

IV. Special Provisions for Bankruptcy of Securities Firms

Given the exponential growth in capital markets in the past 50 years and the number of companies servicing the market, it was inevitable that there would be a greater number of securities firm failures. The insolvency of securities firms has unique challenges. Such firms often actively trade in large volume, and at any given point, a securities firm holds securities for customers in the form of securities in the name of the securities firm, with the customer as beneficial owner only; holds securities in the customer's name but endorsed such that the securities firm can trade at its discretion or at the customer's discretion; some hold securities in the customer's name and such securities are segregated; and/or the firm holds customers' cash arising at any given moment from the sale of securities or dividends received but not yet paid to the customer. Each of these types of holding raises issues in respect of whether they are held in trust for the specific investor. Moreover, the conduct of the firm in the

172. See for example, ss. 138.1, Ontario *Securities Act*, *supra*, note 100.

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period immediately prior to bankruptcy may give rise to particular actions by investors against the securities firm, particularly for misrepresentation or other conduct.

Previously, trustees in bankruptcy and other insolvency professionals were left to try to sort out which securities properly belonged to the bankruptcy estate and which were clearly those of the securities firm's customers. At common law, there were complex constructive trust and tracing rules, which in turn often had serious consequences for the size of the pool of assets available for satisfaction of creditors' claims. Investors would argue constructive trust or resulting trust, trying to fit their claims within the various tests for establishing an equitable remedy to their losses. Such customers often sought to trace their funds once in the hands of the securities firm. Such tracing was difficult, expensive and time consuming, as often the funds were commingled or absent such that tracing ownership was futile. Prolonged cases consumed judicial resources with little evidence of a just outcome for investors. In jurisdictions that attempted to utilize these common law doctrines, receivers, or other insolvency administrators would frequently be left holding securities whose value was uncertain or highly fluctuating, preventing the professional from timely disposition of the shares in order to maximize value to the estate. Considerable administrative time and expense was expended in trying to sort out the status of various customers' claims, the form of the securities, and the precise amount of assets available for distribution. Hence, the special statutory provisions enacted in several jurisdictions are aimed at streamlining and clarifying how to address securities firm insolvencies.

In Canada and the United States special statutory regimes for administering securities firm insolvency attempt to create an expeditious and timely means of dealing with such insolvencies. In Canada, the amendments were aimed at creating a completely codified regime, eliminating, for the most part, common law trust arguments, except where a customer's funds are registered in the customer's name.[173]

A. The Canadian regime

In Canada, Part XII of the *BIA* sets out a scheme to govern securities firm insolvencies.[174] Securities firm is defined as a person who carries on the business of buying and selling securities from or to a customer, whether or not as a member of an exchange, as principal, agent or mandatary, and includes any person required to be registered to enter into securities transactions with the public, but does not include a corporate entity that is not within the definition of corporation under the *BIA*.

Part XII was 'enacted to simplify and streamline the administration of a bankrupt securities firm's estate' because the administration of such bankruptcies had been 'time-consuming, complex, uncertain, and costly to both investors and creditors' and often raised trust and tracing concepts that proved difficult to determine.[175] One court observed that: 'often, while waiting for adjudication of these trust claims,

173. In Canada, the *Bankruptcy and Insolvency Act* (*BIA*) was amended in 1997 to add Part XII—Securities Firm Bankruptcies.

174. Section 253, *BIA*.

175. Ashley vs. Marlow Group Private Portfolio Management Inc. (2006) O.J. No. 1195 (Ont. S.C.) at para. 30.

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the trustee would have to continue to hold potentially volatile securities, whose value could plummet, while customers battled over their entitlement to them'.[176]

Under the statutory scheme, securities registered in a customer's name are returned to the customer, and all other cash and securities held by an insolvent securities firm are placed in a general customer pool, and then subsequently distributed on a *pro rata* basis to the firm's customers. The customer pool fund is paid out before any creditors are paid out of a general fund. The operation of Part XII is subject to the rights of secured creditors and nothing in Part XII affects the rights of a party to a contract, including an eligible financial contract[177] with respect to termination, set-off or compensation. Where a securities firm purchases blocks of securities; is registered as the holder of the securities in its own name; and subsequently allocates the securities to its clients, such securities do not constitute 'customer name securities' within the meaning of s. 253 of the *BIA*.

In addition to ordinary creditors, a petition for a receiving order against a securities firm can be filed by a securities regulator, a securities exchange, a customer compensation body such as the Canadian Investor Protection Fund (CIPF), or a receiver. The regulator, exchange, compensation body, or receiver can file the petition where the securities firm has committed an act of bankruptcy within the 6 months before the filing of the application and while the securities firm was licensed or registered by the securities commission to carry on business in Canada. It can also file a petition where a suspension of a securities firm's registration to trade in securities or suspension of membership in a registered securities exchange is in effect when an application is filed, which constitutes an act of bankruptcy if the suspension is due to the failure of the firm to meet capital adequacy requirements.[178]

Under Canadian insolvency legislation, when a securities firm becomes bankrupt, securities owned by the securities firm and securities and cash held by or for the account of the securities firm or a customer, other than customer name securities, vest in the trustee.[179] The trustee is to determine which of the securities in customers' securities accounts are to be dealt with as customer name securities; and advise customers with securities determined to be customer name securities of the determination as soon as possible.[180] 'Customer name securities' means securities that on the date of bankruptcy of a securities firm are held by or on behalf of the securities

176. Ibid.

177. Ibid., within the meaning of subsection 65.1 (8), *BIA*.

178. Section 256, *BIA* a copy of the application must be served on the securities commission, if any, having jurisdiction in the locality of the securities firm where the application was filed.

179. Section 261 (1), *BIA*. Section 253 of the *BIA* specifies that 'Customer' includes (a) a person with or for whom a securities firm in Canadian insolvency legislation deals as principal, or agent or mandatary, and who has a claim against the securities firm in respect of a security received, acquired or held by the securities firm in the ordinary course of business as a securities firm from or for a securities account of that person for safekeeping or deposit or in segregation, with a view to sale, to cover a completed sale, pursuant to a purchase, to secure performance of an obligation of that person, or for the purpose of effecting a transfer, (b) a person who has a claim against the securities firm arising out of a sale or wrongful conversion by the securities firm of a security referred to in paragraph (a), and (c) a person who has cash or other assets held in a securities account with the securities firm; but does not include a person who has a claim against the securities firm for cash or securities that, by agreement or operation of law, is part of the capital of the securities firm or a claim that is subordinated to claims of creditors of the securities firm.

180. Section 260, *BIA*.

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firm for the account of a customer and are registered in the name of the customer or are in the process of being so registered, but does not include securities registered in the name of the customer that, by endorsement or otherwise, are in negotiable form.[181]

Where a customer is not indebted to a securities firm, the trustee is to deliver to the customer the customer name securities that belong to the customer.[182] Where a customer to whom customer name securities belong and who is indebted to the securities firm,[183] discharges their indebtedness in full, the trustee is to deliver to that customer the customer name securities that belong to the customer.[184] If such a customer does not discharge its indebtedness in full, the trustee may, on notice to the customer, sell sufficient customer name securities to discharge the indebtedness.[185] The trustee is then to deliver any remaining customer name securities to the customer.[186]

The trustee is given broad powers in respect of the securities, other than customer name securities. The trustee can exercise a power of attorney in respect of and transfer any security vested in the trustee; sell securities, other than customer name securities; purchase securities; discharge any security on securities vested in the trustee; complete open contractual commitments;[187] maintain customers' securities accounts and meet margin calls; distribute cash and securities to customers; transfer securities accounts to another securities firm; to the extent practicable, comply with customer requests regarding the disposal of open contractual commitments and the transfer of open contractual commitments to another securities firm; and enter into agreements to indemnify the other securities firm against shortages of cash or securities in transferred accounts; liquidate any securities account without notice; and sell, without tender, assets of the securities firm essential to the carrying on of its business.[188]

Where a securities firm becomes bankrupt and property vests in a trustee, the trustee must establish a customer pool fund, including securities obtained after the date of the bankruptcy, but excluding customer name securities and excluding eligible financial contracts to which the firm is a party.[189] The customer pool fund is to include cash, including cash obtained after the date of the bankruptcy, and dividends, interest and other income in respect of securities; proceeds of disposal of securities, proceeds of policies of insurance covering claims of customers to securities; for a securities account of a customer; for an account of a person who has entered into an eligible financial contract with the firm and has deposited the cash with the firm to assure the performance of the person's obligations under the contract,

181. Section 253, *BIA*.
182. Section 263(1), *BIA*.
183. On account of customer name securities not fully paid for, or on another account.
184. Section 263(2), *BIA*.
185. The securities are thereupon free of any lien, right, title or interest of the customer.
186. Section 263(3), *BIA*.
187. Section 253 specifies that 'open contractual commitment' means an enforceable contract of a securities firm to purchase or sell a security that was not completed by payment and delivery on the date of bankruptcy.
188. Section 259, *BIA*. The trustee may act without the permission of inspectors until inspectors are appointed and thereafter with the permission of inspectors.
189. Section 261(2), *BIA* that are held by or for the account of the firm (a) for a securities account of a customer, (b) for an account of a person who has entered into an eligible financial contract with the firm and has deposited the securities with the firm to assure the performance of the person's obligations under the contract, or (c) for the firm's own account.

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or for the firm's own securities account; and specified investments of the securities firm in its subsidiaries.[190]

The trustee is also to establish a general fund, which includes all remaining vested property. Cash and securities in the customer pool fund are required to be allocated in the following priority: for costs of administration to the extent that sufficient funds are not available in the general fund to pay such costs; to customers, other than deferred customers, in proportion to their net equity;[191] and to the general fund.[192] Deferred customer in this context means a customer whose misconduct caused or materially contributed to the insolvency of the securities firm. The trustee must seek court approval to treat a customer as a deferred customer.[193] Where the securities accounts of customers are protected by a customer compensation body that body can also apply to the court for a ruling that a customer should be treated as a deferred customer.[194]

To the extent that securities of a particular type are available in the customer pool fund, the trustee must distribute them to customers with claims to such securities, in proportion to their claims to such securities, up to the appropriate portion of their net equity.[195] Subject to that requirement, the trustee may satisfy all or part of a customer's claim to securities of a particular type by delivering to the customer securities of that type to which the customer was entitled at the date of bankruptcy.[196]

The Canadian legislation specifies treatment where property has been deposited with a securities firm under an eligible financial contract. Where a person has, under the terms of an eligible financial contract with the securities firm, deposited property with the firm to assure the performance of the person's obligations under the contract, and that property is included in the customer pool fund that person is to share in the distribution of the customer pool fund as if the person were a customer of the firm with a claim for net equity equal to the net value of the property deposited that would have been returnable to the person after deducting any amount owing by the person under the contract.[197]

190. Ibid.

191. 'Net equity means, with respect to the securities account or accounts of a customer, maintained in one capacity, the net dollar value of the account or accounts, equal to the amount that would be owed by a securities firm to the customer as a result of the liquidation by sale or purchase at the close of business of the securities firm on the date of bankruptcy of the securities firm, of all security positions of the customer in each securities account, other than customer name securities reclaimed by the customer, including any amount in respect of a securities transaction not settled on the date of bankruptcy but settled thereafter, less any indebtedness of the customer to the securities firm on the date of bankruptcy including any amount owing in respect of a securities transaction not settled on the date of bankruptcy but settled thereafter, plus any payment of indebtedness made with the consent of the trustee after the date of bankruptcy; section 253, *BIA*.

192. Section 262(1), *BIA*. Section 253 specifies that 'deferred customer' means a customer whose misconduct caused or materially contributed to the insolvency of a securities firm and section 258(1) specifies that: 'Where the trustee is of the opinion that a customer should be treated as a deferred customer, the trustee shall apply to the court for a ruling on the matter and shall send the customer a copy of the application, together with a statement of the reasons why the customer should be so treated, and the court may, on such notice as it considers appropriate, make such order as it considers appropriate in the circumstances'.

193. Section 258(1), *BIA*.

194. Section 258(2), *BIA*.

195. Section 262(1), *BIA*.

196. Section 262(2.1), *BIA*; the trustee may, for that purpose, exercise the trustee's power to purchase securities.

197. Section 262(1.1), *BIA*.

In distributing the property in the general fund, priority is given to statutory preferred creditors, and then rateably to: customers, other than deferred customers, having claims for net equity remaining after distribution of property from the customer pool fund and any property provided by a customer compensation body, in proportion to claims for net equity remaining; where applicable, to a customer compensation body to the extent that it paid or compensated customers in respect of their net equity, and to creditors in proportion to the values of their claims; then rateably to creditors that engaged in reviewable transactions and hence are not eligible for a dividend in respect of a claim arising out of that transaction until all claims of other creditors have been satisfied;[198] and finally, to deferred customers, in proportion to their claims for net equity.[199] Hence, the distribution of property under the special provisions for securities firm bankruptcies mirror general priorities under Canadian bankruptcy legislation, but recognizes that the securities firm holds securities for customers and hence that these customers should be paid from a separate pool of capital and not fall within general unsecured creditors' claims. The addition of deferred customers, who are entitled only after the claims of other customers are met, ensures that those who cause the insolvency do not gain an advantage from their actions.[200] The trustee's actions are subject to notice provisions that mirror other sections of the legislation. The trustee of a securities firm is to send customers a statement of customer accounts.[201]

The Ontario Superior Court of Justice has affirmed that section 262(3)(b)(i) of the *BIA* gives a customer compensation body such as the CIPF, although unsecured, payment priority under the general fund over all other unsecured creditors.[202] The Court held that the compensation body had a right to be consulted and involved in negotiations for settlement, particularly important where the CIPF will have to pay off customers of the brokerage firm out of the fund.[203] Where the accounts of customers of a securities firm are protected by a customer compensation body, the trustee is required to consult the customer compensation body during the administration of the bankruptcy, and the customer compensation body may designate an inspector to act on its behalf.[204]

A customer may prove a claim after the distribution of cash and securities in the customer pool fund and is entitled to receive cash and securities in the hands of the trustee at the time the claim is proven up to the appropriate portion of the customer's net equity before further distribution is made to other customers, but no such claim is to affect the previous distribution of the customer pool fund or the general fund.[205] The provision is

198. Section 137, *BIA*.

199. Section 262(3), *BIA*. Section 254. (1) specifies: 'All of the provisions of this Act apply, with such modifications as the circumstances require, in respect of claims by customers for securities and customer name securities as if customers were creditors in respect of such claims. (2) Sections 91–101 apply, with such modifications as the circumstances require, in respect of transactions of a customer with or through a securities firm relating to securities'.

200. On a policy level, however, both deferred customers and reviewable transactions may contribute to a firm's insolvency, and it is unclear why one type of relationship or transaction is preferred over another in this provisions.

201. Section 257, *BIA*, together with notice.

202. *Re Thomson Kernaghan & Co.* (2003), 50 C.B.R. (4th) 287 (Ont. S.C.J. [Commercial List]). The CIPF is discussed below.

203. *Ibid.* at para. 3.

204. Section 264, *BIA*.

205. Section 265, *BIA*.

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aimed at ensuring timely claims to the securities. The trustee is then to prepare a statement indicating the distribution of property in the customer pool fund among customers who have proved their claims and the disposal of customer name securities; or any other report relating to that distribution or disposal that a court may direct.[206]

Hence, the legislation recognizes that securities firms hold the capital of customers and that they are entitled to return of their money to that extent on a *pro rata* basis before unsecured creditors.

The cases under Canadian law highlight the tension between creditors and securities holders in bankruptcy, although for the most part, the statutory provisions appear to have streamlined and clarified how assets are to be dealt with. In particular, the first cases have been primarily disputes with respect to the composition of the customer pool, because making assets available to securities holders means they are not available to meet creditors' claims.

In *Re Vantage Securities Inc.*, a bankrupt securities firm held certain monies in trust for the plaintiff pursuant to a contractual arrangement unrelated to its securities business.[207] The plaintiff sought to exclude the property based on trust provisions under the *BIA* that specify that trust property held by a bankrupt does not form part of the bankrupt's assets. The trustee in bankruptcy denied the claim on the basis that cash under Part XII meant all cash, including trust cash and that pursuant to s. 255 of the *BIA*, which specifies that where provisions in Part XII are in conflict with any other provision of the *Act*, they take precedence.[208] The British Columbia Supreme Court, in affirming the trustee's decision, held that on the plain reading of the statute, the section did not exclude trust property. The Court held that by enacting Part XII, Parliament's objective was to simplify the resolution of trust claims from customers of securities firms and to simplify securities firm bankruptcies by eliminating the myriad of competing trust claims and the associated legal costs and time delays.[209] It held that the amendments were aimed at removing the entire concept of trust law for securities except where those securities are customer named securities and cash when the bankrupt company was a securities firm.[210] The Court held that pursuant to s. 261 (1), all cash vested in the trustee, not just cash beneficially owned by the firm.[211]

In another Canadian judgment, *Re Marchment & Mackay Ltd.*, a bankrupt stockbroker firm, after lengthy litigation with securities authorities, had its license revoked and subsequently made an assignment in bankruptcy.[212] Section 262 of the *BIA* exposes the customer pool funds to the costs of administration of the estate in bankruptcy, given that securities other than customer name securities vest in the trustee. The maximum amount that can be paid out to a customer of a bankrupt for 'direct out

206. Section 266, *BIA*.
207. *Re Vantage Securities Inc.* (1998) 64 B.C.L.R. (3d) 148; 9 C.B.R. (4th) 169 (B.C. S.C. [In Chambers]).
208. Section 255, *BIA* specifies: 'All the provisions of this Act, in so far as they are applicable, apply in respect of bankruptcies under this Part, but if a conflict arises between the application of the provisions of this Part and the other provisions of this Act, the provisions of this Part prevail'.
209. *Ibid.* at para. 10.
210. *Ibid.* at para. 12. The Court held that for all other real or personal property held by a bankrupt securities firm, trust principles continued to apply.
211. *Ibid.* at para. 13.
212. *Re Marchment & Mackay Ltd.* (2000), 16 C.B.R. (4th) 247 (Ont. S.C.J. [Commercial List]).

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of pocket losses' under the requisite trust plan is Cdn $5000.[213] The Court was satisfied that this amount was Cdn $5000 and not Cdn $5000 less amounts that may be recovered otherwise than out of the trust plan.[214] The Court held that the plan should be given a purposeful, fair, and liberal interpretation, observing the unique nature of the customers' loss in that the securities and cash were rightly assets to which they would be unquestionably entitled to but for the assets vesting in the trustee under Part XII. The Court held that by filing a voluntary assignment in bankruptcy, the bankrupt brokerage firm put securities that had been ordered and not delivered beyond the bankrupt's ability to follow further customer directions as such securities vested in the trustee.

In *Ashley v. Marlow Group Private Portfolio Management Inc.*, the Marlow group of companies had operated as securities and investment dealers and investment advisers.[215] It was placed into receivership when more than Cdn $3 million disappeared from clients' trust accounts and its operations were suspended by the Ontario Securities Commission. The receiver was to identify and secure the assets, quantify the losses and determine the distribution of the remaining funds. A number of issues arose in the case, including, whether securities were being held in trust and thus should be returned to investors; whether Marlow Group's situation should be administered through a bankruptcy proceeding; and whether Marlow Group was in fact a securities firm within the meaning of Part XII of the *BIA*, because buying and selling securities was allegedly not Marlow Group's primary business activity, rather investment advice was. The receiver sought direction on placing the assets into the customer pool.[216]

The Ontario Superior Court of Justice considered the issue of what is a securities firm. In Canada, French, and English versions of the statutory language have equal authority, and here, the definition of securities firm did not completely align in its language. In comparing the French and English versions of the statutory provision, the Court found that the English version contained the phrase 'carries on the business', suggestive of being one's primary business, whereas the French version was silent on this language.[217] The Court held that a reasonable interpretation of the definition was that it included a corporation that buys and sells securities as part of its business, not that it had to be its primary business.[218] Thus, the broad definition

213. The Ontario Securities Commission requires as a condition of brokerage registration that securities firms enter into a trust agreement for the general purpose of protection of customers of securities firms, *ibid.* at para. 3.

214. Ibid. at para. 4. The Court observed that the thrust of the limitation is to avoid a double recovery for a specific item of loss; here, recovery from Marchment's estate in bankruptcy of other items was not a double recovery.

215. Ashley vs. Marlow Group Private Portfolio Management Inc., 2006 CarswellOnt 3449 (2006) O.J. No. 1195, 19 C.B.R. (5th) 17 (Ont. S.C.J. [Commercial List]).

216. Some of the securities claimants sought the return of their securities to avoid inclusion in the pool, in order that they would receive 95% of the value of their claims, compared with 60% of value if included in the customer pool.

217. Section 253, *BIA*.

218. Relying on section 18 of the Canadian *Charter of Rights and Freedoms*, the Court held that both versions were equally authoritative that the French version formed part of the context in which the English version needed to be interpreted, and the court's role is to find a common interpretation. The Court held that the reference to 'including any person required to be registered' meant that the definition was not limited to such persons.

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of 'securities firm' was determined to be unambiguous, and a corporation that buys and sells securities as part of its business falls under the definition of securities firm and is subject to the application of Part XII.[219] The Court also held that since the provisions applied equally to cash and securities, accordingly, 'all securities held by the securities firm at the date of bankruptcy vest in the trustee, not just the securities owned beneficially by the firm'.[220] The only exclusion from the pool is the customer name securities. Section 255 specifies that to the extent that Part XII conflicts with other provisions of the *BIA*, Part XII prevails; and since cash and securities held in trust for the benefit of customers vest in the trustee, then Part XII prevails over the *BIA* trust provisions and trust claims are prohibited.[221] The Court also dismissed the receiver's motion for substantive consolidation based on concern about the lack of evidence of the effect on all creditors if there was substantive consolidation; however it held that the estates were to be procedurally consolidated and administered together.[222]

Another issue in *Ashley v. Marlow Group Private Portfolio Management* was whether units in a limited partnership could be re-registered in the claimants' names before assignment into bankruptcy in order to qualify them as customer name securities holders.[223] The Court determined that the corporate defendant held the units in trust for the claimants, which placed them in the same position as the other securities that were not customer name securities, and as they were not the subscribers, the Court concluded that there was no basis to require the register to be altered. Thus, all of the disputed assets were found to be part of the customer pool fund.[224]

In *Re White*, the claimant sought a declaration that it was the beneficiary of a constructive trust, as its money had flowed through a third party to the bankrupt.[225] It sought recovery of trust monies from the estate of the bankrupt. The Registrar observed that for purpose of the application, the bankrupt was likely involved in a ponzi scheme that collapsed shortly after the money had been transferred.[226] The Registrar held that while the transaction in question involved a security, there was no evidence that the defendant, though registered to sell securities, was carrying on business as a securities firm, and thus the definition of securities firm was not met and Part XII was not applicable. The Registrar also found that the situation did not warrant the imposition of a constructive trust or finding of unjust enrichment as there was not sufficient evidence of wrongful conduct to engage the court's conscience and in the circumstances, it was not appropriate to alter the *BIA* scheme of distribution.[227]

219. The court interpreted 'recorded' as including situations where there is another specified method of recording ownership, such as limited partnerships.

220. Re Marchment & Mackay Ltd., supra, note 212 at para. 60; and citing section 261, *BIA*. The Court held that on a plain reading of the statute that 'held for a customer' meant cash and securities held in trust or for the benefit of a customer.

221. Part XII prevails over s. 67 trust provisions.

222. Ashley vs. Marlow Group Private Portfolio Management Inc. (2006), 22 C.B.R. (5th) 126 (Ont. S.C.J.), at paragraphs 78, 79.

223. Ibid. at para. 67.

224. Ibid. at para. 67. According to the Limited Partnership Agreement and the *Limited Partnership Act*, it was required that the names and addresses of the limited partners be registered on the records of the limited partnership, and according to the Prospectus, a partner was entitled to request that the shares be registered in his/her name.

225. Re White, 2006 WL 3004129, 2006 CarswellOnt 6424 (Ont. S.C.J.) (Registrar).

226. Ibid. at para. 16.

227. Ibid. at paragraphs 20, 24.

Portus Alternative Asset Management Inc. is the most complex case to date involving the special statutory scheme for insolvency of securities firms.[228] It involved the collapse of a related group of corporations, the Portus Group, whose affairs were substantially intertwined and extremely complex. One aspect of the case involved a motion by a group of investors for segregation of the assets of their fund for their benefit, rather than have their fund be a part of the bankruptcy of Portus Alternative Asset Management ('PAAM'). PAAM was the investment advisor to the Market Neutral Preservation Fund ('MNPF'), which was an open-ended trust in which units were sold to accredited investors through various registered market intermediaries without a prospectus, in reliance on prospective exemptions available under Ontario securities legislation.[229] MNPF used the Cdn $19 million from sale of its units to purchase the Canadian Basket, a basket of non-dividend paying Canadian securities listed on the Toronto Stock Exchange (TSX). The Canadian basket was pledged as security to Royal Bank of Canada ('RBC') for the obligations of MNPF under a forward contract.[230] The MNPF was not in the name of Portus, nor in its care; the account was held at another financial institution that was designated as prime custodian of the assets. The only role that PAAM played in the MNPF structure was as investment adviser.

Also implicated in the case was the MNB Trust, which was an open-ended trust in which RBC was the sole unitholder, owning all outstanding 1.9 million units; and for which PAAM was the trustee and Portus Asset Management Inc. ("PAM"), the investment manager. Under the terms of the forward agreement between MNPF and RBC, RBC agreed to pay to MNPF on maturity an amount equal to the redemption proceeds of units in the MNB Trust in exchange for the delivery of the Canadian Basket by MNPF to RBC.[231] In order for MNPF to realize value, the MNB Trust was required to dispose of its assets for cash and then distribute the net asset value to RBC as its sole unitholder; and pursuant to the forward contract, RBC was to deliver the net asset value of the MNB Trust units held by it to MNPF and it in turn would deliver the Canadian basket to RBC.[232] The complex structure was conceived to maximize investment return while minimizing the tax impact.[233] Funds did not flow as intended under various agreements and subsequently, almost Cdn $3 million in funds was diverted and disappeared. A cease trade order was issued and a receiver was appointed in respect of PAAM, PAM, and related entities in 2005, and the assets subject to receivership included the MNPF investment structure and a managed

228. Ontario (Securities Commission) vs. *Portus Alternative Asset Management Inc.* (2006), 19 C.B.R. (5th) 17 (Ont. S.C.J. [Commercial List]) at para. 3.

229. Ibid. at para. 9. The MNPF investors subscribed approximately Cdn $19.2 million.

230. The RBC forward contract was entered into between RBC and MNPF pursuant to which the RBC was to pay to MNPF, on the maturity date or pre-settlement date, as applicable, an amount equal to the redemption proceeds of units of MNB Trust in exchange for the delivery by MNPF to RBC of the Canadian basket, *ibid.*, Appendix, para. 18.

231. Ibid. at para. 11.

232. Ibid. at para. 11.

233. Ibid. at para. 14.

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account structure (MAS).[234] A further judgment ordered that the assets were to be dealt with in one bankruptcy proceeding.[235]

A key issue was whether one group of investors, the Market Neutral Preservation Fund investors ('MNPF Investors') was entitled to segregation of the assets of the MNPF for their benefit or whether the assets should form part of the bankruptcy of PAAM, in which case the MNPF investors would be treated the same as the other investors.[236] The MNPF Investors sought to avoid the customer pool and realize on the MNPF assets. The MNPF assets were managed by PAM.[237] While the Market Neutral offering was being conducted, PAAM began a distinct business by making its investment management services available to a less restricted class of investors by offering to manage the assets of any clients of third party dealers on a discretionary basis, rather than engaging in the direct sale of investment products like Market Neutral to accredited investors. Investors in this MAS class of investors executed an account application with PAAM and paid to it their investment money; however, the majority of these assets were deposited in the Market Neutral Account. The MAS did not provide investors with actual units in a specific fund, but rather, the investment management agreements specified that PAAM intended to invest all the assets in the account in a structure that was intended to provide investors with substantially the same economic effect of investment in a bank note trust series.[238] The MAS was not properly established, and more than Cdn $618 million was commingled with the MNPF account.

The Court declared that all the assets held by the various entities in the Portus group were property of PAAM and that all the people who invested with or through the debtor were customers within the meaning of Part XII of the *BIA*, preserving the rights of the MNPF investors to bring a claim asserting proprietary and tracing claims to the MNPF assets held in the name of PAAM.[239]

The Court accepted the general proposition as set out in *Vantage*, *supra*, and confirmed in *Marlow*, *supra* that the Canadian regime went as far as possible to eliminate competing claims by vesting most assets of a bankrupt securities firm in the bankruptcy trustee.[240] It held that the fact that the motion is made before, rather than during, bankruptcy was not determinative, as here there was a receiving order that placed control of assets in a receiver in circumstances where clearly bankruptcy was anticipated, and thus regard should be had to the effect on the result assuming bankruptcy. The determination during a receivership that contemplates bankruptcy should not produce a substantially different result from what would occur in bank-

234. Ontario (Securities Commission) vs. *Portus Alternative Asset Management Inc. (Receiver of)*, (2005) O.J. No. 5548 (Ont. S.C.J. [Commercial List]).

235. Ontario (Securities Commission) vs. *Portus Alternative Asset Management Inc.* (2005) O.J. No. 6080 (Ont. S.C.J. [Commercial List]). With the court preserving the right of one group of investors to argue at a subsequent hearing that a particular set of assets did not form part of the bankrupt estate.

236. Ontario (Securities Commission) vs. *Portus Alternative Asset Management Inc.*, *supra*, note 194 at para. 2. At the initial date of receivership, Ontario bonds proceeds, SGP call options (collectively the 'MNPF Assets' were located in an account with RBC Dominion Securities Inc. ('RBC').

237. The trustee was Computershare Trust Company of Canada.

238. Ontario (Securities Commission) vs. *Portus Alternative Asset Management Inc.*, *supra*, note 220 at para. 32.

239. Ibid. at para. 36.

240. Ibid. at para. 100.

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ruptcy, given the public goals of Part XII of the *BIA*.[241] The Court held that the claims of the MNPF Investors commenced with an actual trust.[242] It held that while the provisions were intended to bring clarification, certainty and expedition to claims against securities firms, they were not intended to operate to defeat claims arising from a specific trust where those assets have been improperly commingled and could be traced.[243]

The Court in *Portus* accepted that Part XII of the *BIA* was enacted to overcome issues that arose in the context of the bankruptcies of securities firms by ranking investors equally against the customer pool fund and ranking investors ahead of others with respect to the cash and securities in the customer pool fund and that the broad public purpose behind the regime for securities firm bankruptcies was evidenced by the override of Part XII to other sections of the *BIA*.[244] However, the Court concluded that the position advanced by the MNPF Investors was not incompatible with the public purpose behind Part XII because the MNPF Investors were beneficiaries under specific contract and entitled to return of specific trust assets; PAAM was not a necessary party to the carrying out of the objects of that trust, it could have been any entity; the trustee duties of PAAM could have been carried out by a non-securities firm as trustee; the MNPF Investors were able to trace the assets of the MNPF Trust directly to the account at RBC;[245] and in performing trustee functions in respect of MNPF Investors, PAAM was not acting as a securities firm.[246] The Court held that it is not inconsistent with the public purpose of Part XII to exclude investor claims to which there is a clear, traceable contractual entitlement caught only because there is said to be the incidental involvement of a securities firm, when the transactions could have been lawfully and properly carried out by a non-securities firm.[247] Hence, the Court held that the MNPF Investors were entitled to the funds in the MNPF/Co. PAM Account in the name of PAAM as trustee and to the proceeds of the MNB Trust at RBC that could be segregated as being for the account of MNPF Investors.[248]

The Portus case is ongoing at the time this paper goes to press and numerous issues have yet to be resolved. The complexity of the corporate structure and the particular circumstances highlight, however, that statutory provisions that were created for ordinary securities law failures may not be entirely appropriate for cases in which

241. Ibid. at para. 101.

242. Distinguishing cases such as *Re Ivaco Inc.* (2005), 12 C.B.R. (5th) 213 and *General Chemical Canada (Re)* (2005) O.J. No. 5436 (QL), 2005 CarswellOnt 7306, in which claims arose in the context of a deemed trust, in the context of pension benefit claims, *ibid.* at para. 102.

243. Ibid. at para. 106, specifically, of s. 261 of the *BIA* and related sections.

244. Ibid. at paragraphs 107, 108, provided for in s. 255. The avoidance of the time and cost associated with resolution of complicated claims to priorities involving securities firms was a mandate in clear language in the statute; however, the question was whether s. 261 (1) has such broad reach that it should catch all transactions to which the section might apply, no matter how incidental they may be. *Ibid.* at paragraphs 111, 112.

245. Ibid., in which it held the MNPF Account as well as the MNB Trust.

246. The Court observed that the fact that PAAM happened to be a securities firm should not be conclusive, *ibid.* at paragraphs 113, 114.

247. Ibid. at para. 115. The Court noted that the circumstances in which a claim such as that of the MNPF Investors would arise is likely to be infrequent, based on particular facts, and that otherwise, the goal of Part XII could be impaired.

248. Ibid. at para. 120.

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the firm's failure is due to fraud or other securities law violations. The next cases will be critically important in determining whether the scope of the statutory language is sufficient to remedies harms created by misconduct or whether the courts will have to step in and exercise their gap-filling authority under the *BIA* to ensure that there are effective remedies for customers that have been harmed by securities law violations or criminal conduct.

In Canada, proposed amendments to insolvency legislation, if proclaimed in force, will clarify Part XII to specify that cash and securities covered by the provisions includes cash and securities held by any person for the account of the securities firm.[249] The objective is to clarify that all securities and cash, held by or for the securities firm, excluding customer name securities, are subject to the distribution rules in Part XIII of the *BIA*.[250]

Canada has established the CIPF as a mechanism to address losses to investors on insolvency of brokerage firms, and since its inception in 1969, CIPF has paid claims totaling $37 million to eligible customers of 17 insolvent member firms.[251] Funded by industry members, CIPF covers customers of members who have suffered or may suffer financial loss solely as a result of the insolvency of a member. Such loss must be in respect of a claim for the failure of the member to return or account for securities, cash balances, commodities, futures contracts, segregated insurance funds or other property received, acquired or held by the member in an account for the customer. Eligible claims may include the return of securities, cash balances, commodities, futures contracts, segregated insurance funds, or other property received, acquired or held by the member in an account for the customer. CIPF does not cover customers' losses that result from other causes such as changing market values of securities, unsuitable investments or the default of an issuer of securities. Claims that are eligible for coverage are normally settled by ensuring that the trustee has sufficient assets to transfer the customer accounts to another member and CIPF will return the customer's cash and securities, within limits, when a CIPF member becomes insolvent. As noted above, pursuant to the *BIA*, all customers share proportionately according to their net equity in the assets that make up the customer pool fund. If there is a shortfall, CIPF coverage is available to eligible customers.[252]

B. The U.S. scheme in respect of insolvent securities firms

The United States is another example of a jurisdiction that has enacted a special statutory regime for securities firm insolvencies. In the United States, the *Securities Investor Protection Act of 1970* (*SIPA*) was enacted to protect investors against financial

249. Section 261, proposed amendments to the *BIA*, Statutes of Canada Chapter 47, not yet proclaimed in force as of 15 June 2007.

250. Bill-55 (Chapter 47): clause-by-clause analysis, online: Strategis, http://strategis.ic.gc.ca/epic/internet/incilp-pdci.nsf/en/h_cl00790e.html.

251. http://www.cipf.ca/c_home.htm.

252. Ibid.

losses arising from the insolvency of their brokers.[253] Although the U.S. *Bankruptcy Code* provides for a stockbroker liquidation proceeding, it is more common that a failed securities firm is addressed in a *SIPA* proceeding than a *Bankruptcy Code* liquidation proceeding.[254] Both regimes allows for the return of customer name securities.

The difference between liquidation under the U.S. *Bankruptcy Code* and the *SIPA* is that under the *Code*, the trustee is charged with delivering customer name securities, but then converting all other securities to cash expeditiously and making cash distributions to customers of the debtor securities firm in order to meet their claims. In contrast, a *SIPA* trustee is to distribute securities to customers to the greatest extent practicable, and to this end, there is a statutory grant of authority to the trustee to purchase securities to satisfy customers' net equity claims to specified securities.[255] Hence, *SIPA* is aimed at placing customers in as close a position as possible that they would have been had the firm not become insolvent. This is accomplished by seeking to preserve the investor's portfolio as it stood on the filing date.[256] Trustees appointed under the *Bankruptcy Code* do not have the resources to try to meet fully the claims, and hence their role is to protect the filing date value of the customers' securities by liquidating all non-customer name securities and distributing the cash.[257] Where customer names securities and Securities Investor Protection Corporation (SIPC) advances are not sufficient to satisfy the full net equity claims of customers, the customers are entitled to participate in the estate as unsecured creditors.[258]

The *SIPA* advances its statutory purpose by according those claimants in a *SIPA* liquidation proceeding who qualify as 'customers' of the debtor priority over the distribution of customer property.[259] Customer property is defined as cash and securities at any time received, acquired or held by or for the account of a debtor from or for the securities accounts of a customer, and the proceeds of any such property transferred by the debtor, including property unlawfully converted.[260] The trustee must promptly deliver customer name securities to the debtor's customers, distribute the fund of "customer property" to customers, and pay, with money from the SIPC fund, remaining creditors' net equity claims to the limits provided for.[261] As under the Canadian legislation, each customer shares ratably in the customer property fund of

253. *Securities Investor Protection Act of 1970*, 15 U.S.C. § 78 aaa *et seq.* (SIPA); *SEC vs. S.J. Salmon & Co.*, 375 F. Supp. 867, 871 (S.D.N.Y. 1974).

254. *Bankruptcy Basics*, Administrative Office of the United States Courts Public Information Series, April 2004 at 53.

255. *SIPA*, 15 U.S.C. §§ 78fff-2(d), *Ibid.* at 55. The trustee is required to deliver customer name securities if the customer is not indebted to the debtor; if the customer is indebted, the customer may, with approval of the trustee, claims securities in his or her name upon payment to the trustee of the amount of indebtedness, 15 U.S.C. §§ 78fff-2(c)(2) The trustee can also, with the approval of the SIPC, sell or otherwise transfer to another member of SIPC, without the consent of a customer, all or any part of the account of a customer, 15 U.S.C. §§ 78fff-2(f).

256. *Bankruptcy Basics, supra*, note 254 at 55.

257. *Ibid.*

258. 15 U.S.C. §§ 78fff-2(c)(1).

259. *SIPA*, 15 U.S.C. §§ 78fff-2(b) & (c)(1), 78111(4). Customer is defined as: 'Any person . . . who has a claim on account of securities received, acquired, or held by the debtor in the ordinary course of business as a broker or dealer from or for the securities accounts of such persons for safekeeping, with a view to sale, to cover consummated sales, pursuant to purchases, as collateral security or for the purposes of effecting transfer. The term "customer" includes any person who has a claim against the debtor arising out of sales or conversions of such securities, and any person who has deposited cash with the debtor for the purchase of purchasing securities'.

260. *SIPA*, 15 U.S.C. §§ 78111(4).

261. *SIPA*, 15 U.S.C. §§ 78fff-2(a)–(c).

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assets to the extent of the customer's net equity at the time of filing. If the fund of customer property is insufficient to make the customers whole, the fund created by the *SIPA* funds the difference up to a specified limit. The *SIPA* fund is capitalized by the general brokerage community.[262] The current limits of protection are set at U.S. $500,000 claim per customer for securities, and U.S. $100 000 per customer for cash.[263]

When a brokerage firm fails, the SIPC will arrange to have the brokerage's accounts transferred to a different securities firm; and if it is unable to arrange the transfer, the failed firm is liquidated.[264] The SIPC sends investors either the certificates for the securities that were lost or a cheque for the market value of the shares.[265] The commencement of a *SIPA* case is undertaken by filing an application for a protective decree with the U.S. district court, and if proceedings are granted, any pending bankruptcy liquidation proceedings are stayed until the *SIPA* action is completed.[266] The district court has the authority to grant a stay pending determination of the application for a protective decree, including actions pending under the bankruptcy proceeding, and it also has the discretion to appoint a temporary receiver.[267] The *SIPA* specifies that the district court will grant a protective decree if the debtor consents, the debtor fails to contest the application, or the district court finds one of four conditions specified in the *SIPA*.[268] Once a protective decree is granted, a trustee is appointed and the district court orders removal of the proceeding to the bankruptcy court in the same judicial district as an adversary proceeding for liquidation.[269] The bankruptcy court is to convene a hearing within 10 days, on notice to customers and creditors, on the disinterestedness of the trustee, where parties can object. If the SIPC is the trustee, it is deemed disinterested.[270] The objectives and process of a *SIPA* liquidation are described by the Administrative Office of the United States Court in the following way:[271]

> The purposes of a SIPA liquidation are: (1) to deliver customer name securities to or on behalf of customers, (2) to distribute customer property and otherwise satisfy net equity claims of customers, (3) to sell or transfer offices and other productive units of the debtor's business, (4) to enforce the rights of subrogation, and (5) to liquidate the business as promptly as possible. 15 U.S.C. § 78fff(a). To the extent possible, consistent with SIPA, the liquidation is conducted in accordance with chapters 1, 3, 5, and subchapters I and II of chapter 7 of Title 11. 15 U.S.C. §78fff(b). A section 341 meeting of creditors is conducted

262. SIPA, 15 U.S.C. §§78fff-3, 78ddd; *SEC vs. Packer, Wilbur & Co.*, 498 F.2d 978, 980 (2d Cir. 1974).
263. SIPA, 15 U.S.C. §§ 78fff-3. See also the Securities Investor Protection Corporation, *2005 Annual Report*, www.sipc.org.
264. The SEC is responsible for regulating and supervising the activities of the SIPC under its rule making power for self-regulatory organizations; *Bankruptcy Basics, supra*, note 254 at 60.
265. Bankruptcy Basics, ibid. at 53.
266. Bankruptcy Code, 11 U.S.C. § 742; *SIPA*, 15 U.S.C. § 78aaa *et seq.*
267. SIPA, at 15 U.S.C. §§ 78eee(b)(2)(B)(I-iv).
268. SIPA, at 15 U.S.C. §§ 78eee(b)(1).
269. The *Bankruptcy Basics* book issued by the Administrative Office of the U.S. Courts specifies that there are historical reasons for using an adversary proceeding, and that *SIPA* specifies that certain features under the *Bankruptcy Code* are applicable in *SIPA* proceedings, *supra*, note 254 at 56.
270. SIPA, at 15 U.S.C. §§78eee(b)(6)(A) and (B).
271 *Bankruptcy Basics supra*, note 254 at 57.

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by the trustee. Non-customer claims are handled as in an asset case. Costs and expenses, and priorities of distribution from the estate, are allowed as provided in section 726 of Title 11. Funds advanced by SIPC to the trustee for costs and expenses are recouped from the estate, to the extent that there is any estate, pursuant to section 507 of Title 11.

The trustee's powers under a *SIPA* liquidation are almost identical to those of a trustee in bankruptcy.[272] The trustee has responsibility for investigating the acts, conduct, and condition of the debtor securities firm and making a report to the court.[273] The trustee also reports periodically on its progress in distributing cash and securities to customers.[274]

The *SIPA* requires the SIPC to make advances to the trustee in order to satisfy claims, either in the form of cash to customers with claims or to purchase securities to satisfy net equity claims in lieu of cash, including the administrative costs of meeting these claims, up to a maximum of U.S. $500 000 per customer.[275] The SIPC can elect in particular circumstances to undertake direct payment to customers outside of bankruptcy proceedings; specifically, where the claims of all customers aggregate less than U.S. $250 000, the debtor is financially distressed as defined by law and the cost to the SIPC for a direct payment process is less than for liquidation through the courts.[276]

While there was only one firm failure in 2005 in which the SIPC had to intervene, in the past 35 years, it has commenced 314 proceedings of which 283 were completed by the end of 2005.[277] While not all proceedings were bankruptcy proceedings, all did involve firms in financial difficulty. Under the regime, the exchanges, the SEC, and the National Association of Securities Dealers report to SIPC concerning broker-dealers that are insolvent or approaching financial distress. If SIPC determines that it is necessary to act, it applies to a Federal district court for the appointment of a trustee.[278] In some circumstances, SIPC may pay customer claims directly as advances. Since the *SIPA* was enacted, cash and securities distributed for customers of broker-dealers in financial difficulty have totaled U.S. $14.1 billion, of which U.S. $13.8 billion came from debtors' estates.[279]

Customer-related property of the debtor is allocated in the following order: first to SIPC in repayment of any advances made to the extent they were used to recover

272. Those powers vested in a Chapter 7 U.S. *Bankruptcy Code* trustee.

273. *SIPA*, 15 U.S.C. §78fff-1(b)(2). The trustee also reports to SIPC and other persons as the court may direct.

274. *SIPA*, 15 U.S.C. §78fff-1(c).

275. *Bankruptcy Basics, supra,* note 254 at 59; 15 U.S.C. §78fff-3(a). If part of the claim is for cash, the total amount advanced cannot exceed USD 100 000, 15 U.S.C. §78fff-3(a)(1).

276. *SIPA*, 15 U.S.C. §78fff-4(a). The court could still be utilized to resolve disputes, but the process remains a transaction between the SIPC and the debtor's customers, without the expense of a trustee and court proceedings.

277. Securities Investor Protection Corporation, *2005 Annual Report, supra,* note 263 at 6. Twenty-six involved pending litigation matters and five involved claims still being processed. The one proceeding for 2005 was Austin Securities Inc. 314 represents less than 1% of the securities firms and broker-dealers in the U.S. In *Stephenson vs. Deutsche Bank AG, Deutsche Bank Securities Inc., Deutsche Bank Securities Limited, Wayne Breedon et al, Case No. CV02-4845 RHK/AJB (D. Minn.)* the trustee sued the Deutsche Bank-related entities and a Deutsche Bank stock-loan trader and others, in connection with an alleged massive securities fraud. The suit was joined by Ferris Baker Watts, Inc., E*Trade Securities, LLC, CIBC World Markets, Inc. and other securities firms. The trustee reached a settlement at a settlement conference before the magistrate judge, including agreement to withdraw claims, paying the trustee USD 147.5 million in cash. The settlement was approved by the bankruptcy court, and as a result of the settlement all the claims were to be paid in full; *SIPC vs. MJK Clearing Inc.*, Adv. Proc. No. 01-4257 RJK (Bankr. D. Minn. Jan. 18, 2006). The trustee also reached agreement with E*Trade with respect to the competing claims they both had in the bankruptcy case of Native Nations Securities, Inc., *ibid.* at 10.

278. *Ibid.* at 4.

279. *Ibid.*

securities apportioned to customer property; second, to customers of the debtor on the basis of their net equities; third to SIPC as subrogee for the claims of customers; and fourth, to SIPC as repayment of advances made by SIPC to transfer or sell customer accounts to another SIPC member firm.[280]

The U.S. litigation arising out of securities' firm insolvencies has focused on whether claimants were customers within the meaning of the *SIPA*;[281] the validity of claims and the enforceability of guarantees post-liquidation;[282] issues of controlling persons in connection with related companies and liability under the alter ego doctrine;[283] potential liability of compliance principals under a bankruptcy;[284] potential liability of general partners in a bankruptcy;[285] and alleged fraudulent transfers.[286] SIPA requires the claimant to establish customer status by requiring that a debtor's obligations to its customers be 'ascertainable from the books and records of the debtor' or otherwise established to the satisfaction of the trustee.[287] The courts have generally given a narrow interpretation to the term 'customer' and required evidence of a timely written complaint in respect of the securities where the claimant believes that the trades were unauthorized.[288] However, the fact that the property is missing, for unauthorized trading or otherwise, does not affect customer status.[289]

280. Bankruptcy Basics, supra, note 254 at 59.

281. Stafford vs. Giddens (In re New Times Securities Services, Inc.), Case No. CV-05-0008 (JS) (E.D.N.Y. 16 August 2005), reversed U.S. Court of Appeals for the second Circuit 463 F.3d 125, 2006 U.S. App. Lexis 22855; 47 Bankr. Ct. Dec. 13 2006; *Edward G. Murphy, Inc. Profit Sharing Plan, et al* vs. *Selheimer & Co. Inc. and SIPC* No. 02-6847 (E.D. Pa. 23 Feburary 2003); *In re Klein, Maus & Shire, Inc.* 301 B.R. 408 (Bankr. S.D.N.Y. 2003); *Arford vs. Miller (In re Stratton Oakmount, Inc.)* 210 F.3d 420 (2d Cir. 2000). These include failing to discharge the burden of proof in terms of timely objection in writing to alleged unauthorized trades (*In re Klaus, Maus & Shire, Inc.* 2002 Bankr. LEXIS 1786 (Bankr. S.D.N.Y.) and declining protection under *SIPA* in the absence of a claimant demonstrating that he or she met contractual obligations 'within a reasonable time of receipt of a trade confirmation of the transaction in question and/or monthly account statement in accordance with the instructions' (*In re Klaus, Maus & Shire, Inc.* 2002 Bankr. LEXIS 1784 (Bankr. S.D.N.Y.).

282. See for example, *Stephenson* vs. *Greenblatt et al. (In re MJK Clearing, Inc.),* 408 F.3d 512 (8th Cir. 2005).

283. Mishkin vs. Gurian (In re Adler, Colman Clearing Corp.), 399 F.Supp.2d 486 (S.D.N.Y. 2005), whereby the trustee sued Gurian for payment of USD 150 million in judgments that the trustee had obtained against numerous Bahamian shell companies allegedly used to commit securities fraud that ultimately led to the debtor's financial collapse. The Court held Gurian to be a controlling person of the companies under the common law doctrine of alter ego and the *Securities and Exchange Act,* section 20.

284. Lutz vs. Chitwood (In re Donahue Securities, Inc.), Case No. C-1-05-010 (S. D. Ohio, 6 September 2005), where the district court affirmed the decision of the bankruptcy court dismissing the trustee's claims against a compliance principal of the firm for negligent supervision and breach of fiduciary duty on the basis that the wrongdoer was the employer of the compliance principal and because the allegations were insufficient to establish a fiduciary relationship between Chitwood and the debtor's customers.

285. SIPC vs. Murphy (In re Selheimer & Co.), 319 B.R. 395 (Bankr. E.D. Pa. 2005); *Murphy vs. Selheimer (In re Selheimer & Co.)* ,319 B.R. 384 (Bankr. E.D. Pa. 2005); *SIPC vs. Murphy (In re Selheimer & Co.),* Adv. Prc. No. 04-0669 (Bankr. E.D. Pa. April 12, 2005), appeal allowed, *Murphy vs. SIPC,* Civ. Action No. 05-2311 (E.D. Pa. Oct. 14, 2005).

286. Picard vs. Taylor (In re Park South Securities, LLC), 326 B.R. 505 (Bankr. S.D.N.Y. 2005), where the trustee sued on the basis of fraudulent transfers.

287. 15 U.S.C. § 78fff-2(b); *In re Klein, Maus & Shire, Inc.* 301 B.R. 408 (Bankr. S.D.N.Y. 2003) at 22.

288. Ibid., see also *In re Adler Coleman Clearing Corp.,* 204 B.R. 111, 115 (Bankr. S.D.N.Y. 1996); *In re A.R. Baron Co., Inc.,* 226 B.R. 790, 795 (Bankr. S.D.N.Y. 1998); *In re MV Securities, Inc.* 48 B.R. 156, 160 (Bankr. S.D.N.Y. 1985); *Schultz vs. Omni Mut., Inc.* (1993) Fed. Sec. L. Rep at 98 (S.D.N.Y. 1993).

289 *In re Klein, Maus & Shire, Inc.* 301 B.R. 408 (Bankr. S.D.N.Y. 2003) at 28; *In re Adler Coleman Clearing Corp.,* 198 B.R. 75 (Bankr. S.D.N.Y. 1996) at 75.

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For example, in *Stafford v. Giddens (re New Times Securities Services Inc.)*, the U.S. Court of Appeals for the Second Circuit reversed a judgment of the district court that had allowed claims under the *SIPA*.[290] In the aftermath of the bankruptcy of two brokerage firms, the plaintiffs claimed entitlement as customers as defined by *SIPA* to recover their losses from a ponzi scheme engineered by the principal of the firms, in which he pretended to invest in genuine money market funds and issued fraudulent promissory notes.[291] The plaintiffs had been induced to liquidate their accounts at the brokerage firm and make a loan to the brokerage firm. The trustee for the *SIPA* liquidation concluded that the plaintiffs were lenders, not customers, and denied their claims to *SIPA* funds. The bankruptcy court agreed with the trustee and the district court reversed. The Court of Appeals reversed again and remanded the case to the district court with instructions to reinstate the judgment of the bankruptcy court.

The Court of Appeals in *Stafford vs. Giddens* observed that judicial interpretations of customer status support a narrow interpretation of the *SIPA*s provisions, drawing a distinction between customers and those in a lending relationship.[292] The Court held that whether an individual enjoys customer status turns on the transactional relationship; and that a loan unrelated to trading activities in the securities market does not qualify for *SIPA* protection. The Court held that the *SIPA* assumes that a customer, as an investor in securities, wishes to retain his or her investments despite the liquidation of the broker and that the statute is therefore aimed at exposing the customer to the same risks and rewards that he or she would have enjoyed had there been no liquidation.[293] The Court applied the principle that a customer's legitimate expectations at the date of filing determine the nature and extent of customer relief under the *SIPA*. The Court's determination of these expectations are informed by examining written confirmation of transactions and what customers expect to have in their accounts on the filing date.[294] The Court concluded that the plaintiffs had decided to swap their *SIPA*-protected securities investments for non-protected loan instruments and hence their only legitimate expectation must have been that they were lenders; and while they were defrauded, *SIPA* does not protect against all cases of alleged dishonesty and fraud.[295] It rejected the district court's conclusion that because the plaintiffs were fraudulently induced to invest in the promissory notes, their legitimate expectations froze at the moment their sold their securities. This situation was in contrast to that in another case, *In re New Times Securities Services*, because in the latter case, even though the securities were fictitious, the investors had a legitimate expectation that they had invested in securities.[296]

290. Stafford vs. Giddens (In re New Times Securities Services, Inc.), U.S. Court of Appeals for the Second Circuit 463 F.3d 125, 2006 U.S. App. Lexis 22855; 47 Bankr. Ct. 13 December 2006.
291. Ibid., citing *In re New Times Securities Services*, 371 F.3d 68, 71 (2d Cir. 2004).
292. Ibid., citing *In re Stalvey & Assocs., Inc.*, 750 F.2d 464, 472 (5th Cir. 1985); *SEC vs. F.O. Baroff Co.*, 497 F.2d 280, 282 n.2 (2d Cir. 1974); and *In re Hanover Square Sec.*, 55 B.R. 235, 238-39 (Bankr. S.D.N.Y. 1985).
293. Ibid. at 10.
294. Ibid., citing *Miller vs. DeQuine Revocable Trust (In re Stratton Oakmount, Inc.)* 2003 U.S. Dist. LEXIS 20459, No. 01-CV-2812 (S.D.N.Y. 14 November 2003).
295. Ibid. at 14.
296. Ibid. citing *In re New Times Securities Services* 371 F.3d at 71–72, 86.

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As a public policy matter, it is apparent that there could be greater public education such that investors better understand the risk and rewards of investing in capital markets and what preventive measures they might wish to consider minimizing their losses on securities firm insolvency. In the U.S., for example, investors should ensure that securities they purchase are registered in their name as soon as possible after their purchase. The difficulty with this preventive strategy is that often securities are never registered in the investor name, and although investors are the beneficial owners of the securities, they would still fall within the customer pool provisions of various statutory schemes. It is also important that investors deal with securities firms that are members of national protection funds, such as the CIPF in Canada or SIPC in the United States, as this will ensure greater protection of their investment, and frequently timelier payout of cash or transfer of securities. As a risk reduction strategy, it also makes sense for investors to diversify their investment holdings across several securities firms, reducing their risk of loss from firm failure.

V. Conclusion

At the heart of all the issues canvassed in this paper is the allocation of risk and the allocation of remedies at the point of firm insolvency. It is uncontested that in the ordinary course of business, equity claims come last in the hierarchy of claims. What is less clear is whether this should encompass all equity claims or whether claims arising from the violation of public statutes designed to protect equity investors ought to be treated differently. Discerning the optimal allocation of risk is a complex challenge if one is trying to maximize the simultaneous advancement of securities law and insolvency law public policy goals. The U.S., the U.K., and Australia have all used legislation to establish the subordination of equity claims to those of creditors, with Canada soon to follow suit.

The challenge is to advance the protection of investors as much as possible while recognizing the importance of the priority scheme of credit claims under insolvency legislation. The critical question is the nature of the claim advanced by the securities holder, and is it more properly characterized as a claim in equity arising out of ordinary business risk, or is it more akin to a claim of an unsecured creditor where the claim arises from a statutory violation under securities or corporate law. It would seem that absolute subordination of all shareholder claims is overreach by insolvency legislation that may give rise to inappropriate incentives for corporate officers within the insolvency law regime where restructuring is an option.

The U.S. has provided a limited statutory exception to complete subordination through the fair funds provisions of the *Sarbanes-Oxley Act*. Courts have permitted the SEC claims for penalties and disgorgement to rank equally with unsecured claims even though the funds are to be distributed to shareholders. The U.K. and now Australian schemes permit shareholders to claim directly as unsecured creditors for fraudulent acts and misrepresentation by the issuer. Canada alone of the countries discussed in this paper has not come to grips with the distinction between ordinary

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equity claims and those based on wrongdoing either legislatively or judicially. What are the options and policy grounds for adopting a particular approach?

Several policy options were canvassed in Part III. The first was that only new purchasers of securities would have claims arising from securities law violations ranked equally with unsecured creditors, on the basis that existing shareholders arguably have access to information such that they can be monitoring their risk; however, there may be problems with this approach based on public policy considerations discussed above. It is unclear that there has been a cogent public policy rationale advanced for the proposition that shareholders and creditors should be treated differently in respect of securities laws violations where neither contracted for fraud risk and frequently neither have the capacity to monitor against such risk. Another option is to grant securities regulators enhanced powers such that disgorgement of funds and penalties paid for misconduct can be directed towards investors harmed by the misconduct of the debtor corporation or its officers, as has occurred in the U.S. The positive aspects of this remedy, including the gatekeeping role of the SEC, need to be weighed realistically against whether a jurisdiction would commit the resources and energy to securities enforcement to make such remedies meaningful or effective. Another option would be to treat shareholder claims arising out of securities law violations as unsecured claims. Here too, there are a number of consequences that would have to be considered in order to design a framework that was expeditious and fair for the valuation and resolution of such claims.

These and other options need to be carefully developed as part of an ongoing public policy debate. It seems unclear why jurisdictions are moving on the one hand to enhance the remedies available to securities holders for corporate misconduct and on the other hand proposing that if the conduct is sufficiently egregious that satisfaction of claims makes the company insolvent, then the claims are completely subordinated to other interests in the firm. Most critically for the resolution of securities law claims within insolvency proceedings is whether there is a mechanism that can determine the validity and value of claims in an expeditious manner that would still allow equity claimants to participate in insolvency proceedings.

There are numerous other policy questions that continue to be underdeveloped and which are beyond the scope of this paper. One is to consider the changing nature of risk in equity investments. For example, pension funds are considered to be sophisticated investors that are able to monitor corporations for misconduct and hence should bear the full brunt of the risk/reward paradigm in corporate law in that they have bought equity understanding the risk associated with this form of investment. While this is true, the global move to defined contribution plans from defined benefit plans means that losses from corporate misconduct are borne more directly by employees and pensioners contributing to the funds. One reason to consider a different policy is that the people are not just investing their spare money in equity, but rather they are being used to fund pensions and retirements savings, so there is a bigger effect than individuals losing surplus money that they are investing in equity markets. Moreover, if there is fraud or misrepresentation that causes damage to the

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value of equity, it is not the risk that workers or their pension funds bought into any more than it is the risk that creditors bought into.

Another question that requires further scholarly attention is whether there are lessons for states with emerging capital markets and developing securities law regimes in respect of how to reconcile the exigencies of both insolvency legislation and securities legislation. How can pursuit of securities holders' claims be facilitated at the same time as creating mechanisms for timely resolution of such claims so that there can be an expeditious resolution to the insolvency? These and other questions deserve further study and public policy debate. While securities law and insolvency law regimes may not always sit comfortably with one another, they do need to be reconciled to achieve the simultaneous advancement of the public policy goals of each.

A further area that was not addressed in this paper and for which research is needed is the impact of electronic transfer of securities legislation, in particular, the challenges posed with multiple intermediaries, and the status of a security where a transfer is made just prior to insolvency proceedings. Transactions may be set aside on the basis that the transfer was made in a specified period leading up to insolvency, those periods varying considerably across jurisdictions. However, the risk of insolvency and consequent setting aside of transfers can be problematic in settlement systems as delivery is highly dependent on different securities transfer rules and different systems. A number of jurisdictions are enacting securities transfer legislation that begins to address these issues. Further research regarding the management of legal risks is required.

Numerous jurisdictions have not hesitated to adopt a codified response to the time and resources consumed in trying to deal with the various common law tracing claims by customers in a securities firm insolvency. Of course, an important difference is that the customers' claims originate as property claims whereas the fraud and misrepresentation claims of shareholders are not founded on property rights. However, there may be elements of such models that could be applied generally in fashioning a framework to deal with securities law claims in insolvency proceedings.

If the public policy goal of both securities law and insolvency law is to foster efficient and cost-effective capital markets, it seems that the systems need to be better reconciled than currently. From a securities law perspective, there must be confidence in meaningful remedies for capital markets violations if investors are to continue to invest. From an insolvency perspective, creditors make their pricing and credit availability choices based on certainty regarding their claims and shifting those priorities may affect the availability of credit. In this respect, however, it is important to note that recognizing claims arising from securities law violations would not affect the realization of claims by secured creditors, who would continue to rank in priority and who generally set the thresholds for pricing of credit. Further study and public policy debate about the intersection of these important areas of law is required.

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TAB 10

The Intersection Between Shareholders' and Creditors' Rights in Insolvency: An Australian Perspective

*Jason Harris** and *Anil Hargovan***

I. INTRODUCTION

The conventional view that debt ranks ahead of equity during corporate insolvency is well understood and applied in many jurisdictions around the world, including, until recently, in Australia. The blanket subordination of equity claims in corporate insolvency, whether by common law precedent or via specific statutory subordination rules, is a practice that Australian corporate insolvency law shared in common with other countries including Canada and the United States.

However, as a result of statutory interpretation by the High Court of Australia in *Sons of Gwalia Ltd v. Margaretic*,[1] the traditional principle of blanket shareholder subordination is now under strain in the Australian jurisdiction. In a landmark decision in 2007, the High Court of Australia elevated a group of shareholder claims to rank equally with the claims of the general body of unsecured creditors. In strengthening the legal claims of shareholders, arising from the acquisition of shares on the basis of misleading conduct or inadequate disclosure, the unprecedented decision in *Sons of Gwalia* has focussed attention on whether the law represents good public policy and strikes the right balance between creditors' and shareholders' rights in insolvency.

Current insolvency law in Australia is at a crossroads, with the federal government poised to decide whether to affirm or reject the doctrine of blanket

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1 (2007), 232 ALR 232; [2007] HCA 1 (hereinafter *Sons of Gwalia*).

subordination. On 7 February 2007, the Australian federal government requested that the Corporations and Markets Advisory Committee ("CAMAC") consider whether law reform is necessary to protect and promote the rights of shareholders to be kept properly informed by market disclosure requirements, and whether private remedies for defective disclosure should be classed as provable debts in corporate insolvencies.[2]

The use of investor protection laws, particularly through securities class actions, has highlighted a tension in Australian corporate law between the ability of shareholders to enforce their statutory rights for damages for defective and misleading disclosure practices, and traditional priority rules in insolvency with shareholder claims placed below those of non-shareholder creditors.

These events may be paralleled with developments in the United States where major corporate collapses of Enron and Worldcom have left hundreds of thousands of shareholders (including employees who invested their pension plans in corporate stock) out of pocket. The scale of these collapses, and the extent of misinformation provided to the market in an effort to prop up the share price, has called into question the effectiveness of market disclosure laws if actions by defrauded investors are subject to blanket subordination when the company enters insolvent administration.

In the United States, the Congress reacted to these scandals by enacting "the most significant and far-reaching securities legislation since the 1930s"[3] (the *Sarbanes-Oxley Act* 2002), which provides an exception to the traditional rule of blanket subordination by allowing the Securities and Exchange Commission ("SEC") to bypass the insolvency distribution process and distribute penalties for securities law breaches directly to defrauded shareholders.[4] Significantly, whether deliberate or not, cracks are now apparent in the long established doctrine of blanket shareholder subordination in the United States as a result of the enactment of the Federal Account for Investor Restitution (or Fair Fund for Investors) for recoveries on behalf of injured investors.[5] The Fair Fund

2 See http://www.camac.gov.au for details of the inquiry.

3 Statement of Stephen Cutler, Director, Division of Enforcement of the SEC, made at Congressional hearing. See "Its Only Fair: Returning Money to Defrauded Investors" U.S. House of Representatives, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises Committee on Financial Services, 26 February 2003, Serial No. 108-4 (http://commdocs.house.gov/committees/bank/hba86851.000/hba86).

4 See further Pt II.

5 For discussion, see Part II. See further, Z Christensen, "The Fair Funds for Investors Provision of Sarbanes-Oxley: Is it Unfair to the Creditors of a Bankrupt Debtor?" [2005] University of Illinois Law Review 339; Marvin Sprouse III, "A Collision of Fairness: Sarbanes-Oxley and S 510(b) of the Bankruptcy Code" [2005] American Bankruptcy Institute Journal (available at http://images.jw.com/com/publications/528.pdf); Douglas Henry, "Subordinating Subordination: WorldCom and the Effect

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figure includes distributions to inv

7 Speech by SEC Commissioner An
Institute on Securities Fraud" 28 S
2006/spch092806aln.htm).

8 The absolute priority rule provides
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Inc., 241 F. 3d 552 at 554 (7th cir
of discussion in US law reviews:
absolute priority" [1991] Annual S
Thomas Jackson, "Bargaining afte
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greatly expands the compensation available to victims of securities law fraud, with more than $1 billion distributed to date,[6] and over $8.5 billion in Fair Fund money ordered.[7]

Vesting the SEC with discretion to apply civil penalties collected, as part of any disgorgement funds obtained from corporate defendants, for the benefit of injured investors, exposes the tension with the doctrine of blanket subordination and the entrenched "absolute priority rule".[8] In cases of bankruptcy, the discord between a policy of blanket shareholder subordination (discussed below) and the protection of injured investors through a restitution plan under the *Sarbanes-Oxley* reforms becomes apparent. In contrast, proposed amendments to Canadian insolvency law contained in Bill C-62 seek to impose the blanket subordination of all "equity claims", without any recourse for defrauded shareholders.

The snapshot of recent developments in Australian and United States corporate and insolvency law, described above, illustrates a growing recognition of shareholder interests and entitlements in insolvency law. There is an inherent tension between the traditional rule that equity claims finish after debt claims, and the increasing importance placed on protecting the integrity of market disclosure by giving defrauded investors actions and compensatory remedies against the corporation for breach of securities laws. This paper will examine recent developments in the treatment of shareholder claims for defective disclosure in insolvency in Australia, and attempt to contextualise the developing Australian rules with respect to parallel developments in North America.

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of Sarbanes-Oxley's Fair Funds Provision on Distributions in Bankruptcy" (2004) 21 Emory Bankruptcy Developments Journal 259.

6 "SEC Press Release: SEC Announces $125 Million Fair Fund Distribution to Investors Injured by Pilgrim Baxter Market Timing Fraud" 23 April 2007 (http://www.sec.gov/news/press/2007/2007-68.htm). The Director of the Division of Enforcement has quoted an even larger figure of more than $1.8 million in Fair Funds distributed to injured investors. See, "Columbia Investors Get their Fair Share", 2 July 2007 at http://www.1-Wires.com/story.asp?s=14940). However, it is important to note that this figure includes distributions to investors of solvent firms as well.

7 Speech by SEC Commissioner Annette Nazareth, "Remarks before the ABA National Institute on Securities Fraud" 28 September 2006 (http://www.sec.gov/news/speech/2006/spch092806aln.htm).

8 The absolute priority rule provides that senior creditors must be satisfied before junior creditors are entitled to payment. Thus, secured creditors receive payment before unsecured creditors, who must receive payment before members: *Wilkow v. Forbes Inc.*, 241 F. 3d 552 at 554 (7th circ., US Court of Appeals, 2001). There is a wealth of discussion in US law reviews: see for example Elizabeth Warren, "A theory of absolute priority" [1991] Annual Survey of American Law 9 and Douglas Baird, and Thomas Jackson, "Bargaining after the fall and the contours of the absolute priority rule" (1988) 55 University of Chicago Law Review 738.

Part II of the paper examines the theoretical and doctrinal justifications for the subordination of equity claims to debt claims in insolvency. Policy arguments for and against respecting defrauded shareholder entitlements and redefining their rights in insolvency are canvassed. In particular, the paper accepts that shareholders must accept the risk of business failure and have their claims subordinated but queries whether the same result should apply to the risk of being defrauded or misled. Part III examines the statutory subordination of such claims and comments on recent developments in Australia that raise questions about the effectiveness of blanket subordination. The U.S. experience on blanket subordination is surveyed and drawn upon for two principle reasons namely (1) to highlight tensions in the application of such a robust policy; and (2) to highlight a significant change in the law to provide for greater return of moneys to investors, via the Fair Fund provision, victimised by securities law violations. Part IV discusses the future balance in insolvency between equity and debt interests. A comparative perspective is offered with reference to legal developments in U.S. and Canada. Part V reflects on the inherent tension in the competing interests between equity and debt interests in insolvency and concludes that, ultimately, the solution in striking the appropriate balance is a political one.

II. THEORETICAL PERSPECTIVES

1. The contrasting nature of debt and equity interests

The balance between the proportion of equity and debt within the corporation is a matter of individual business preference[9] and is usually influenced by a range of concerns, including taxation, leveraging ratios in the company's industry sector and the market for corporate control.[10] Although the use of debt and equity capital to finance corporations dates back for centuries,[11] their long-standing use should not be misconstrued as demonstrative of a harmony of interests between the two types of capital providers.

9 The pioneering work of Modigliani and Miller shows (according to some limited assumptions such as efficient markets and no taxes) that the actual balance between equity and debt capital does not impact on firm performance: Franco Modigliani and Merton Miller, "The Cost of Capital, Corporation Finance and the Theory of Investment" (1958) 48 American Economic Review 261.

10 For an overview of the literature of capital structuring decisions see W. Megginson, *Corporate Finance Theory* (Reading, Addison-Wesley, 1997), Ch 7.

11 See, for example, the foundational case on the development of floating charge: *Holroyd v. Marshall* (1862), 10 HLC 191, 11 ER 999.

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At the most basic level, there is a tension between the interests of debt holders[12] and equity holders.[13] Both parties have, in one sense, competing claims against the assets of the corporation, although the nature of those claims are fundamentally different. The company's creditors have a *fixed claim* against the company, which may or may not be secured against specific company assets. This claim is based on the amount of the debt plus interest (as specified in the debt instrument). As a trade off for the privilege of limited liability, however, the shareholders have only a *contingent interest*, in that they have bargained for a potentially unlimited increase in the capital value of their shares and (hopefully) future dividend distributions.[14]

While the company remains solvent, and is paying its debts, the interests of members and creditors do not necessarily conflict. This is because the solvency of the company means that it should have sufficient funds to repay all of its debt obligations,[15] with any surplus "profit" being available to retain for future growth or distributed to the shareholders via dividends or a return of capital.

However, when the company approaches insolvency, the assets of the company are insufficient to satisfy in full all of the monetary claims against it. It is at this point that the interests of creditors and members conflict. If the members were able to recoup their investment, the creditors' interests would be prejudiced due to diminished returns. If the assets are divided amongst the creditors (by distributing the proceeds arising from the sale of the assets) the members' investment will be lost. Therefore, at the point of insolvency, the relationship between the equity and debt capital holders may be described as a zero sum game. Indeed, the tension created by this problem has contributed to the increasing importance of corporate rescue statutes around the world, which recognise that a company in financial trouble may be worth more than simply the realizable value of its assets.[16]

It is company law, or more specifically corporate insolvency law, that is given the task of balancing these two competing claimants. Traditionally,

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12 More commonly referred to as creditors, or as "bondholders" in the US.

13 The members of the company, shareholders, or "stockholders" as they are referred to in the U.S.

14 F. Easterbrook and D. Fischel, *The Economic Structure of Corporate Law*, (Cambridge: Harvard University Press, 1991) at 67-70; John Slain and Homer Kripke, "The Interface between Securities Regulation and Bankruptcy-Allocating the Risk of Illegal Securities Issuance between Securityholders and the Issuer's Creditors" (1973) 48 New York University Law Review 261 at 286-7.

15 *Corporations Act 2001* (Cth), s. 95A(1); *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, s. 2; *Bankruptcy Code 1978* (US) s. 101(32).

16 *Corporations Act 2001* (Cth), Pt 5.3A (voluntary administration; *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36; *Bankruptcy Code 1978* (US), Ch 11. See generally, J. Sarra, *Creditor Rights and the Public Interest* (Toronto: University of Toronto Press, 2003); D. Brown, *Corporate Rescue* (Chichester: J. Wiley, 1996).

that task has been completed by subordinating the interests of shareholders until after all of the company's creditors have been paid in full ("blanket subordination"). A rule of insolvency law which prioritises debt over equity creates an economic incentive for shareholders to seek the status of creditors (by any means available) in order to receive a priority distribution (or, as in most insolvencies, any distribution at all). It is quite easy, in the absence of statutory rules to the contrary (as to which see below Pt IV), for members to seek creditor status. All that is needed is a claim that money is owed to them by the company, with the clearest example being a declared, but unpaid, dividend.

Non-shareholder creditors have always viewed attempts by shareholders to claim creditor status with suspicion. As Thayer J. said more than a century ago:[17]

> When a corporation becomes bankrupt, the temptation to lay aside the garb of a stockholder, on one pretense or another, and to assume the role of creditor, is very strong, and all attempts of that kind should be viewed with suspicion.

Indeed, even the celebrated case of *Salomon v. Salomon & Co.*[18] involved an attempt by the liquidator to overturn Salomon's claim to be a secured creditor over the company's assets (which he of course controlled through his majority shareholding).

Despite the underlying tension between debt and equity positions, both are seen as fundamental to the efficient operation of most corporations. Indeed, in an era of large institutional investors, many shareholders (particularly banks) of major corporations are also its creditors.[19] In addition, modern finance techniques may be said to have blurred the traditional line between equity and debt capital. In particular, recent decades have seen the use of hybrid securities, which have elements of both debt and equity capital, become increasingly popular. Modern finance theory suggests that investors should have a balanced portfolio of both equity and debt finance.[20] It may be said that in recent times the stigma of debt and the use of high leveraging have dissipated considerably.

17 *Newton National Bank v. Newbegin*, 74 F. 135 (U.S. C.C.A.8 Kan., 1896) at 140.

18 (1896), [1897] A.C. 22 (Eng. H.L.).

19 There is a growing body of research that considers the challenges of such "universal owners": see the special issue of the journal *Corporate Governance* (2007) 15(3), which presents a range of articles on this topic.

20 This is commonly known as the Capital Asset Pricing Model and is discussed in W. Megginson, *Corporate Finance Theory* (Reading, Addison-Wesley, 1997), Ch 3. For a detailed examination of the corporate governance implications of this theory see Thomas Smith, "The Efficient Norm for Corporate Law: A Neotraditional Interpretation of Fiduciary Duty" (1999) 98 Michigan Law Review 214.

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22 Kenneth Davis, "The Status of D
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23 *Corporations Act 2001* (Cth), ss
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24 See for example, *Securities Act*,
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25 The *Sarbanes-Oxley Act 2002* cr
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26 *Corporations Act 2001* (Cth), ss.

27 *Bankruptcy Code 1978* (US), s. 5

28 The United Kingdom has a simil
s 74(2)(f), however that provisio

Indeed, the private equity wave sweeping the globe is ample demonstration of the popularity, and increasing importance, of debt finance.[21]

Given the importance (some may say predominance) of debt to corporate financing, the maintenance of the traditional rule for subordinating equity claims below debt claims may, at first blush, seem clear and sensible. However, there are also equally strong policy arguments to support parity of equity (or at least some types of equity claims) and debt claims.[22] One of the principle reasons is the fact that at the same time that corporate debt has become increasingly popular, extensive investor protection laws have been introduced across developed capital market economies, including Australia,[23] Canada[24] and the United States.[25] These investor protection laws focus on providing extensive disclosure to the market, to promote efficiency and optimal pricing decisions. Investor protection laws usually also include some form of private enforcement mechanism to provide a compensatory remedy to investors who suffer loss because of securities fraud. This raises the question as to what theoretical justification is there for traditional blanket subordination rules and how those rules should be applied (if at all) against defrauded shareholder claims.

2. Theoretical justification for blanket subordination

As noted above, a fundamental principle of insolvency law is that equity interests should be subordinated to debt interests. In Australia[26] and the United States,[27] this is done via express statutory provisions (discussed below).[28] Whilst

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21 The extensive use of debt has also been fuelled by advantageous tax treatment compared to equity, historically low interest rates and the development of an international market for corporate debt that allows diversification of the risk of corporate lending: for a discussion of private equity see Michael Jensen, "The Eclipse of the Modern Corporation" (1989) 89 Harvard Business Review 61; Luc Renneboog, Tomas Simons, and Mike Wright, "Why do Public Firms go Private in the UK?" (January 6, 2006). Available at SSRN: http://ssrn.com/abstract=873673.

22 Kenneth Davis, "The Status of Defrauded Securityholders in Corporate Bankruptcy" [1983] Duke L.J. 1.

23 *Corporations Act 2001* (Cth), ss. 674 (continuous disclosure), 1041H (misleading or deceptive conduct in relation securities).

24 See for example, *Securities Act*, R.S.O. 1990, c. S.5, Pt. XVIII (continuous disclosure), s. 130 (misrepresentations in prospectus documents).

25 The *Sarbanes-Oxley Act 2002* created new rules to enhance auditor independence, corporate responsibility and financial disclosures and to provide the SEC with new regulatory powers to protect investors.

26 *Corporations Act 2001* (Cth), ss. 553, 563A.

27 *Bankruptcy Code 1978* (US), s. 510(b).

28 The United Kingdom has a similar statutory rule in the *Insolvency Act 1986* (U.K.), s 74(2)(f), however that provision has been read down as not including statutory

in Canada this is currently achieved by common law decisions,[29] legislative amendments propose to introduce statutory subordination rules.[30] The effect of these rules is that debts owed by companies to their shareholders, in their capacity as shareholders (therefore excluding bona fide shareholder loans), are to be deferred until after all non-shareholder debts are paid in full.[31] However, before fully examining the scope of the statutory provisions and its controversial application in Australia[32] and the U.S. (see Pt IV),[33] it is appropriate to focus on the theoretical underpinnings used to justify the subordination of equity claims over debt claims.

As noted above, the fact of insolvency brings with it a deficiency of assets that necessitates a choice on how to distribute the assets of the company amongst its various claimants. There are several distributional models that could be followed. One model is to treat all monetary claims against the company equally, which would require all shareholders and creditors to be paid *pari passu*. The consequences of such a model, particularly with large public corporations with dispersed shareholders, would be to considerably dilute the return to each claimant. The administrative costs of such a system would also be high, given that most companies have far more shareholders than creditors and, in some cases, located widely all over the world.

An alternative model involves making a determination that certain types of claimants should be paid in priority to others. This allows for the senior claimants to receive a return when junior (subordinated) claimants may not. The insolvency laws of Australia, Canada and the U.S. broadly adopt this model, with creditors (fixed claimants) taking a senior position over shareholders (contingent claimants) who are subordinated in so far as their monetary claims arise

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damages claims for misrepresentation brought by shareholders who purchased shares over the secondary market: see *Soden v. British & Commonwealth Holdings Plc.*, [1998] A.C. 298. For a discussion of *Soden*, see Jason Harris and Anil Hargovan, "Sons of Gwalia: Navigating the line between membership and creditor rights in corporate insolvencies" (2007) 25 Company and Securities Law Journal 7.

29 *Blue Range Resource Corp., Re* (2000), 15 C.B.R. (4th) 169 (Alta. Q.B.), discussed further below.

30 Discussed below in Pt III.

31 The legislative language used in Australia and the US differs in some respects, with the Australian provision subordinating debts owed to members "in their capacity as a member" and the US provision subordinates "claims arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, [or] for damages arising from the purchase or sale of such security".

32 *Sons of Gwalia Ltd v. Margaretic* (2007), 232 ALR 232, [2007] HCA 1.

33 For a narrow application of s. 510(b), see *Re Amarex Inc*, 78 B.R. (WD Okla, 1987); *Re Angeles Corp*, 177 B.R. 920 (Bankr CD Cal, 1995); *Re Montgomery Ward Holding Corp*, 272 B.R. 836 (Bankr D Del, 2001). For a wider application, see *Re Telegroup Inc*, 281 F. 3d 133 (3rd Cir, 2002); *Re Geneva Steel*, 281 F. 3d 1173 (10th Cir, 2002).

out of their shareholder status.[34] These jurisdictions go even further by differentiating between different classes of fixed claimants to create a list of priority creditors who must be paid in full before the general (i.e. non-priority) unsecured creditors are paid.[35] The rationale for the priority of particular creditors may be drawn from various sources, including pragmatism (for insolvency administrators), public utility (crown priority) and bargaining inequality (employee wage claims). It is submitted that this model provides greater efficiency than the parity model when examined both *ex ante* and *ex post*.

Ex ante, the distribution is more efficient because the fixed claimants are given some degree of certainty about their chances of recovery, which reduces their need to monitor the company's management. That is, creditors know that they will receive a distribution before shareholders, and that the shareholder's capital contribution will provide a cushion to satisfy (at least partially) their fixed claims.[36] To the extent that the equity capital may be insufficient to satisfy creditor claims, the efficient market hypothesis would dictate that creditors would price their provision of credit in accordance with this degree of risk. By mandating subordination of shareholders claims, the price of credit is reduced because the risk of dilution is reduced compared with the parity model.[37] The increased risk of subordinated equity capital is offset by an increase in the price of equity to compensate for this risk.[38] However, the increased price of equity capital does not necessarily occur because companies may introduce corporate governance measures to reduce the agency costs associated with shareholder monitoring.[39] To the extent that such mechanisms

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34 The statutory and common law subordination of shareholder claims is discussed in detail below.

35 *Corporations Act 2001* (Cth), s 556; *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, s. 136; *Bankruptcy Code 1978* (U.S.), s. 507.

36 This draws on the seminal work by John Slain and Homer Kripke, "The Interface between Securities Regulation and Bankruptcy-Allocating the Risk of Illegal Securities Issuance between Securityholders and the Issuer's Creditors" (1973) 48 New York University Law Review 261.

37 For a financial model predicting an increase in credit costs if shareholder claims are treated with parity to creditor claims, see Christine Brown and Kevin Davis, "Credit Markets and the Sons of Gwalia Judgement" (2006) 13(3) Agenda 239.

38 Jensen and Meckling's model of the optimal corporate capital structure predicts that the cost of equity will rise in response to the increased agency costs associated with monitoring the company's management (in this case because of the shareholder's subordinated position): see Michael Jensen and William Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" (1976) 3 Journal of Financial Economics 305.

39 Michael Jensen and William Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" (1976) 3 Journal of Financial Economics 305.

reduce the risk of managerial delinquency, the improved firm performance will benefit both fixed claimants and contingent claimants.

Subordination of equity claims may also provide corporate governance benefits. A rule of parity between shareholder and creditor claims in insolvency would generate conflicts in the collective monitoring of corporate management. This conflict arises because shareholders (who derive income from increases in the capital value of their shares and dividend streams that come from increased profits) would favour risky activity that could provide a larger return than less risky strategies. Creditors however (as fixed claimants) will receive little tangible benefit from greater profitability if the company adopts aggressive tactics because their debts are fixed. Creditors may therefore prefer a more conservative corporate strategy that will generate more modest profits (at least amounts sufficient to service debt).[40]

This tension between equity and debt claims would necessitate both creditors and shareholders monitoring the conduct of management to pursue actions that support (or at least do not conflict with) their competing interests. Such a position does not accord with governance rules actually adopted by corporate law, which provide shareholders, but not creditors, with extensive powers.[41] The most important power, and one that is common to all jurisdictions considered in this paper, is the power to vote for or against the board of directors at the shareholders meeting. Therefore, a positivist argument can be made supporting the subordination of shareholder claims on the basis that shareholders, not creditors, have the power to monitor and discipline the management of the company through voting.

It is also arguable that a rule of parity between shareholder and creditor claims is not normatively preferable to a rule of subordination. A rule of subordination creates a hierarchy of claims in insolvency with shareholders occupying the position of residual claimants. As residual claimants, shareholders hold the greater risk of losing their investment compared with funds loaned by creditors. This creates a need for shareholders to monitor the corporation's management to ensure that corporate policy attempts to increase total firm value, which allows for the satisfaction of creditors claims and the provision of a profit surplus that may be distributed to shareholders, or if retained, may increase the capital value of the corporation allowing shareholders to realise capital gain

40 B. Cheffins, *Company Law: Theory, Structure, and Operation* (Oxford: Oxford University Press, 1997) at 79-80; W. Megginson, *Corporate Finance Theory* (Reading, Addison-Wesley, 1997) at 332.

41 Whilst it is accepted that creditors may protect themselves in their contracts with the debtor company (which shareholders generally cannot do), it is generally acknowledged that unsecured creditors' contracts are incomplete: Robert Watson and Mahmoud Ezzamel, "Financial Structure and Corporate Governance", in K. Keasey, S. Thompson and M. Wright (eds), *Corporate Governance* (Chichester: J. Wiley & Sons Ltd., 2005) at 54-56.

through selling their shares. Furthermore, as contingent claimants shareholders have a greater incentive to monitor than do creditors as fixed claimants, because their potential benefit is higher. This approach accords with the structure of modern corporate governance laws. Normatively, this structure is more appropriate because it reduces the need for creditors to monitor corporate conduct (because they are given greater chance of recovery) whilst providing an incentive for corporations to adopt internal governance rules that reduce shareholder agency costs and thereby lower the cost of equity capital. This has been explained in depth by the pioneering work of Jenson, Meckling and Fama.[42]

Ex post, the subordination model is more efficient because it provides for smaller meetings (as they are limited to creditors) that have a degree of commonality of interest (or at least have less conflicting interests than exist between shareholders and creditors as a whole), which reduces the cost of corporate insolvencies, compared with a rule that would give shareholders parity. In the Australian jurisdiction, the subordination model is also more efficient because it removes the need to engage in expensive court action to determine issues of causation.[43]

There are, therefore, substantial policy arguments supporting the general subordination of equity claims in corporate insolvency. We must now consider whether these policy reasons extend to all types of equity claims. More specifically, should statutory misrepresentation claims by shareholders induced into purchasing shares in the company by defective market disclosure be subordinated to the claims of non-shareholder creditors?

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42 Michael Jensen and William Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" (1976) 3 *Journal of Financial Economics* 305; Eugene Fama and Michael Jensen, "Agency Problems and Residual Claims" (1983) 26 *Journal of Law and Economics* 327; Eugene Fama and Michael Jensen, "Separation of Ownership and Control" (1983) 26 *Journal of Law and Economics* 301.

43 This is particularly a problem for retention claims where incumbent shareholders allege misleading conduct induced them to not sell their shares. We advocate a model of limited subordination that would allow new shareholders to claim parity with general creditors. The causation issue is not as problematic for new shareholders because they can identify misrepresentations that lead to their purchase. In the United States, the fraud on the market doctrine resolves this issue. The fraud on the market theory does not appear to have been embraced in Canada: see *Carom v. Bre-X Minerals Ltd.* (1998), 41 O.R. (3d) 780 (Ont. Gen. Div.). However, there are various deemed reliance provisions in Canadian securities laws.

3. *Defrauded or Misled Shareholders: Blanket vs Limited Subordination?*[44]

The arguments discussed above have traditionally been raised in the context of prohibiting the competition between shareholder and creditor claims. However, no subordination statute or common law rule supports true blanket subordination so as to deprive a person of an independent right to claim against the company merely because he or she happen also to be shareholders. Shareholders, as individual entities, may interact with the company in different capacities and shareholders may be owed money by the company in different capacities, both as shareholders and as creditors.[45] For example, a shareholder may be owed money because of an unpaid dividend, but may also be owed money through an unpaid loan made by the shareholder to the company. In this simple example, most would accept that the claim of the shareholder as lender (and therefore as an outsider of the company) is qualitatively different from the shareholder's claim for the dividend that arises *because* of his/her status as a shareholder.

Whilst it may be accepted that a monetary claim that does not arise because of the person's shareholding should not be subordinated, what of a statutory claim for damages arising directly because of the purchase of shares? The use of a tortious action to claim damages for misrepresentation inducing the purchase of shares, particularly when the misrepresentation involves the factual substratum giving rise to the company's insolvency, allows shareholders to convert themselves into creditors at the point of insolvency and thereby avoid traditional subordination rules. Should this be permitted? Should insolvency subordination rules triumph over non-insolvency securities law rights? There is a range of diverging views on this vexed issue.

On the one hand, the often-cited article by U.S. law professors Slain and Kripke (which influenced the introduction of statutory subordination in the United States) argued that shareholder misrepresentation claims should be subordination on the basis of the differing bargaining and reliance interests of shareholders and creditors.[46] They argued that shareholders, as investors, should

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44 This section builds on the authors previous work: Anil Hargovan and Jason Harris, "Sons of Gwalia and statutory debt subordination: An appraisal of the North American experience" (2007) 20 Australian Journal of Corporate Law 265; Anil Hargovan and Jason Harris, "The Shifting Balance of Shareholders' Interests in Insolvency: Evolution or Revolution? (2007) 31(2) Melbourne University Law Review (forthcoming).

45 As noted above, Aron Salomon was both shareholder and creditor of A. Salomon & Co Ltd.

46 John Slain and Homer Kripke, "The Interface between Securities Regulation and Bankruptcy-Allocating the Risk of Illegal Securities Issuance between Securityholders and the Issuer's Creditors" (1973) 48 New York University Law Review 261.

bear the risk of fraudulent or misleading conduct in relation to securities as they had the most to gain from the company's success. Investors share in the profits of the business, a benefit not accorded to creditors, who bargain for a fixed return. Accordingly, the authors found it "difficult to conceive of any reason for shifting even a small portion of the risk of illegality from the stockholder, since it is to the stockholder, and not the creditor, that the stock is offered".[47] In other words, the shareholders had knowingly bargained for their subordinated position.[48] Equal treatment to shareholder fraud claims, in their opinion, gives investors the best of both worlds: a claim to the upside in the event that the company prospers and participation with creditors if it fails. This was also recognised by Justice Kirby of the High Court of Australia in the recent *Sons of Gwalia* case:

> . . .investors. . .are not involved in the provision of goods and services to the company, as ordinary creditors are. Their interest in membership of the company is with a view to their own individual profit. Necessarily, their investment in the company involves risks . . . [and] the purchase of shares will commonly entail a measure . . . of speculation. Such speculation would ordinarily be expected to fall on the shareholders themselves, not shared with general creditors who would thereby end up underwriting the investors' speculative risk.[49]

Slain and Kripke provided further support for subordination by asserting that creditors had priced their provision of credit to the company on the basis of, at least partially, a particular level of capital provided by the shareholders (the "equity cushion"). Thus, it is unfair on creditors for shareholders to seek, in effect, to rescind their shareholdings in insolvency by claiming damages for the costs of their shares and thereby removing their capital from the equity cushion.

On the other hand, arguments have been made that the subordination of securities misrepresentation claims by shareholders unjustifiably undermines the policy of market disclosure laws. This argument is supported by several points. Firstly, neither shareholders nor creditors agree to bargain on the basis

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47 John Slain and Homer Kripke, "The Interface between Securities Regulation and Bankruptcy-Allocating the Risk of Illegal Securities Issuance between Securityholders and the Issuer's Creditors" (1973) 48 New York University Law Review 261 at 288.

48 John Slain and Homer Kripke, "The Interface between Securities Regulation and Bankruptcy-Allocating the Risk of Illegal Securities Issuance between Securityholders and the Issuer's Creditors" (1973) 48 New York University Law Review 261 at 267-8. This policy position was quoted in *Re Telegroup Inc*, 281 F. 3d 133 (3rd Cir, 2002) at 140-141; *Re Pre-Press Graphics Co Inc.*, 307 B.R. 65 (ND Ill, 2004) at 75.

49 *Sons of Gwalia Ltd v Margaretic* (2007), 232 ALR 232; [2007] HCA 1 at [109].

of misleading information.[50] Secondly, allowing shareholders to maintain monetary claims in insolvency creates stronger enforcement of disclosure laws which will enhance the efficiency of capital markets, providing benefits for both shareholders and creditors (who also rely on publicly disclosed information to price their credit).[51] Lastly, the increasing use of capital reduction techniques to increase share prices and reward shareholders (driven partially by tax considerations) has also called into question the reality of a meaningful equity cushion upon which creditors rely in pricing their credit.[52]

Rather than advocating blanket subordination or parity between shareholders and creditors, we argue that corporate insolvency law may pursue a policy of limited subordination. In advocating a limited approach to subordination, we favour an approach which recognises the informational disparities between *certain* shareholders and the company's creditors.

It is submitted that shareholders who purchase shares in the company due to a misrepresentation by the company are in a similar position to contract creditors. When an investor (large or small) is deciding whether to purchase shares in the company (either by way of prospectus or through the secondary market), that investor will rely upon the information that the company has disclosed to the public. However, creditors also rely upon this same publicly available information. Prior to the acquisition of shares, the investor is not in a superior position to the general creditors. Thus, if the investor suffers a loss because of a misrepresentation inducing the initial purchase of shares, the creditors will also suffer a loss because they would not have provided credit to the company either on those terms, or perhaps not at all, if they had been aware of the true state of affairs. Therefore, we argue that *new* shareholders who claim misrepresentation damages should have parity in insolvency with general unsecured creditors and should not be subordinated.

However, the same cannot be said for *pre-existing* shareholders and therefore their legal treatment for misrepresentation damages upon insolvency should differ from that of *new* shareholders. As noted by Callinan J. (albeit in dissent) in *Sons of Gwalia*, shareholders have extensive rights and powers that creditors do not have (such as the right to attend meetings and the ability to sue for oppression). This supports the view that it is unfair for those same shareholders to seek to change their position by standing as creditors and thereby to recover (at least part of) their investment. After all, the *quid pro quo* of limited liability is the risk of losing the full price of the shares owned by each member. To allow shareholders to claim back their investment, allows shareholders the

50 Kenneth Davis, "The Status of Defrauded Securityholders in Corporate Bankruptcy" [1983] Duke L.J. 1 at 62.

51 Kenneth Davis, "The Status of Defrauded Securityholders in Corporate Bankruptcy" [1983] Duke L.J. 1 at 65.

52 See John Armour, "Share Capital and Creditor Protection: Efficient Rules for Modern Company Law" (2000) 63 Modern Law Review 355.

rights, powers and benefits of investment, without the concomitant risks. Creditors bargain for a fixed return, while shareholders bargain for variable (but hopefully higher) gains through increases in capital value or by dividend payments. Thus, as also recognised by Justice Kirby[53] and Justice Callinan[54] in *Sons of Gwalia*, it is arguably unfair to allow all shareholders to stand as creditors.

It should be noted though that the rights, powers and benefits of shareholding only arise when the investor is a 'member' of the company (i.e., when they are registered shareholders).[55] A prospective investor is not a member of the company (either in law or equity) prior to the purchase of shares. This means that when a misrepresentation is made by the company to the market, the existing shareholder has a power and informational advantage over both the company's general creditors and the prospective investors. In our view, it is this advantage that justifies subordination, not the mere fact of membership. Thus, unlike the U.S. position, we advocate subordinating only the claims of existing shareholders and allowing investors induced to purchasing shares in the company (either directly or indirectly) to claim in the company's liquidation as they were equally as vulnerable and innocent as the company's general creditors.

Apart from notions of fairness, this approach would also answer many of the concerns regarding the impact of the decision in *Sons of Gwalia*. It is unlikely to result in large numbers of shareholders making claims, because only those shareholders who purchased shares in the company within a short time after the misrepresentation would escape subordination. All existing shareholders would be subordinated and investors who purchased shares long after the misrepresentation would have difficulty establishing a casual nexus between the misrepresentation and their purchase under current law, and could be denied proof by the liquidator. Thus, the only situation where shareholders would not be subordinated would involve a company making a misrepresentation to the market which induced at least some new investors to purchase shares in the company, and where the company then entered insolvency administration soon after. In such situations, shareholder success is still not guaranteed as causation is difficult to prove in the absence of a rule similar to the fraud on the market rule that operates in the U.S. Causation, however, is an evidentiary matter separate from the issue dealing with shareholder classification as a creditor and their equal ranking with unsecured creditors.

Despite the risk of the defrauded investor not being fully compensated, either through failure to prove causation or through lack of funds by the insolvent debtor company, this policy approach is still capable of promoting investor confidence which is an important policy goal of modern securities legislation.[56]

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53 *Sons of Gwalia Ltd v Margaretic* (2007), 232 ALR 232; [2007] HCA 1 at 109.

54 *Sons of Gwalia Ltd*, (2007), 232 ALR 232 at 208-210.

55 *Corporations Act 2001* (Cth), s. 231.

56 Kenneth Davis, "The Status of Defrauded Securityholders in Corporate Bankruptcy" [1983] Duke L.J. 1 at 64.

The policy approach advocated recognises the importance of promoting new investment in equity capital markets while balancing the responsibilities of existing shareholders to use their extensive powers to better monitor management and enhance corporate governance.

4. Doctrinal Support for Subordination

Aside from theoretical arguments, there are also strong doctrinal reasons for the subordination of shareholder claims. Australia, Canada and the U.S. have all, at various times, had leading judicial decisions that provided for the subordination of shareholder claims until after non-shareholder creditors are satisfied in full.

Australian law adopted and applied corporate insolvency principles from the United Kingdom for the majority of the 19th and 20th centuries.[57] This meant that the applicable precedent concerning the treatment of shareholder claims in insolvency was the U.K. House of Lords' decision in *Houldsworth v. Glasgow Bank*.[58] That case involved a claim for damages based on misrepresentation made by a shareholder in the failed City of Glasgow bank. The shareholder (Houldsworth) claimed that he was misled into purchasing shares in the unlimited company prior to its collapse into liquidation, and sought damages to indemnify himself against calls by the liquidator. The House of Lords ruled that it was improper for a shareholder to seek damages for misrepresentation inducing the purchase of shares whilst still remaining a shareholder of the company. Given that earlier authorities had determined that a shareholder could not rescind the contract to purchase shares from the company once it entered liquidation,[59] Houldsworth was effectively prevented from bringing his claim for damages. The reasoning for this view was explained by Earl Cairns in the following manner:[60]

> If [Houldsworth] succeeds in that action, this £4000 will be paid out of the assets and contributions of the company. But he has contracted, and his contract remains, that these assets and contributions shall be applied in payment of the debts and liabilities of the company . . . The result is, he is making a claim which is inconsistent with the contract into which he has entered, and by which he wishes to abide; in other words, he is in substance, if not in form, taking the course which is described as approbating and reprobating, a course which is not allowed either in Scotch of English law.

57 The right to appeal to the Privy Council was removed in Australia only in 1986.
58 (1880), 5 App. Cas. 317 (Scotland H.L.).
59 *Oakes v. Turquand* (1867), L.R. 2 H.L. 325 (U.K. H.L.).
60 (1880), 5 App. Cas. 317 (Scotland H.L.), at 325 per Earl Cairns LC.

Thus, it can be seen that the rationale underpinning the refusal to allow Houldsworth's claim is the perceived inconsistency between his contribution of capital to the company (and his consequential liability to pay calls) with his claim for damages based on misrepresentation inducing the purchase of shares. By claiming damages, Houldsworth was effectively seeking to rescind his share purchase on the basis of the misrepresentation. The court was clearly concerned about the shareholder insulating himself from the liability he had contracted to meet by purchasing his shares.

It is important to note that the *Companies Act 1862* (U.K.), s. 38(7) which operated at the time of *Houldsworth* (and has been substantially reproduced in subsequent statutes) provided for statutory subordination by stating that debts owed to members in their capacity as members were deemed not to be a debt of the company "payable to such member in a case of competition between himself and any other creditor not being a member of the company". Despite the existence of a statutory scheme of subordination, the reasons given in *Houldsworth* did not refer to the provision and rather were based on the general law.

The decision in *Houldsworth* was applied soon after in *Re Addlestone Linoleum Co*,[61] where an attempt by a shareholder to claim damages for breach of contract in respect of discounted preference shares was denied because of the statutory subordination provision (interpreted in light of the reasoning in *Houldsworth*). It should also be noted that the position in the U.K. did not stand still in the 20th century. Professor Gower extensively criticised the decision in *Houldsworth* in his leading treatise on company law, which in its later editions argued that the decision did not withstand the introduction of the *Misrepresentation Act* in 1967.[62] In 1989, that position was confirmed by statutory amendment of the *Companies Act 1985* (U.K.), which introduced what is now s. 111A:[63]

> A person is not debarred from obtaining damages or other compensation from a company by reason only of his holding or having held shares in the company or any right to apply or subscribe for shares or to be included in the company's register in respect of shares.

These developments did not flow through into Australian legislation. However, in 1998 the U.K. House of Lords' decision in *Soden v British & Commonwealth Holdings Plc*[64] found that the U.K. subordination provision did not apply to a misled shareholder who purchased their shares over the secondary

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61 (1887), 37 Ch. D. 191.

62 L. Gower, *The Principles of Modern Company Law* (3rd ed, London: Stevens and Sons, 1969) at 319.

63 This is repeated in s. 655 of the new *Companies Act 2006* (U.K.).

64 [1998] A.C. 298.

market (through a takeover). In that case, the court limited the operation of the term "in their capacity as a member" to debts that arose because of the statutory contract, or otherwise because of a special benefit conferred only on members. This line of reasoning was an important influence on the recent *Sons of Gwalia* decision by the High Court of Australia, discussed below.

Australian corporate insolvency laws contained an identical subordination provision to s. 38 of the U.K. statute, and U.K. decisions were applied on several occasions in lower courts without controversy until the early 1990's.[65] At that point the High Court of Australia had the opportunity to consider the Australian statutory subordination provision in *Webb Distributors (Aust) Pty Ltd v. Victoria*.[66] That case concerned the claim for damages by investors in the failed Pyramid Building Society of Victoria based upon alleged misrepresentations that the investments were withdrawable "like deposits in a bank". The majority of the High Court of Australia found that the misled shareholders were prohibited from bringing their claims because of statutory subordination provision, as interpreted by the rule in *Houldsworth*.[67] Thus, up until the recent *Sons of Gwalia* litigation, it was generally accepted that claims by shareholders for misrepresentation damages inducing the purchase of shares could not be raised in competition with the claims of non-shareholder creditors.

In Canada, there is (at present) no statutory subordination of shareholder misrepresentation claims when a company becomes insolvent.[68] There is however, a consistent line of precedent that mandates the strict subordination of such claims. The leading decision is *Re Blue Range Resource Corp.*,[69] which concerned a shareholder who submitted a proof of debt in the corporate reorganisation (under the CCAA) of Blue Range Resource Corporation. The proof was based upon an unliquidated claim for fraudulent misrepresentation inducing the shareholder's purchase of shares over the secondary market.[70] The moderator rejected the proof and the shareholder sought a declaration from the court that its claim was meritorious (in effect to enable it to stand alongside unsecured

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65 See for example, *Re Dale & Plant Ltd* (1889), 43 Ch. D. 255; *Re Harlou Pty Ltd* [1950] VLR 449.

66 (1993), 179 C.L.R. 15.

67 The recent decision in *Sons of Gwalia* raises doubts about whether the previous decision in *Webb Distributors* was correct in regard to significance of *Houldsworth* in interpreting the statutory subordination provision and its application to statutory misrepresentation claims. This is discussed below in Pt III.

68 See further Janis Sarra, "From Subordination to Parity: An International Comparison of Securities Law Claims in Insolvency Proceedings" (2007) 16 International Insolvency Review Pt II C. We express our thanks to Professor Sarra for providing an advance copy of this article.

69 (2000), 15 C.B.R. (4th) 169 (Alta. Q.B.).

70 The facts in this case are similar to those in the leading U.K. decision in *Soden v British & Commonwealth Holdings Plc* [1998] A.C. 298, although with the opposite result.

creditors in the restructuring). Romaine J. denied the claim on the basis that claims by shareholders (as shareholders) should be subordinated to those of the non-shareholder creditors.

Romaine J. stated (at 17) that:

> It is clear that in common law shareholders are not entitled to share in the assets of an insolvent corporation until after all the ordinary creditors have been paid in full.

Romaine J. accepted that shareholders may have claims against the insolvent company that did not depend upon their status as shareholders in which case they would not be subordinated, however in this case the cause of action depended on Big Bear's purchase of shares and was therefore inseparable from its standing as a shareholder.[71]

This led Romaine J. to consider that the shareholder's claim was essentially a return of capital:[72]

> A tort award to Big Bear could only represent a return of what Big Bear invested in equity of Blue Range. It is that kind of return that is limited by the basic common law principal that shareholders rank after creditors in respect of any return on their equity investment.

Romaine J. justified her refusal to allow the shareholder to stand alongside unsecured creditors on several grounds:[73]

- Creditor priority over shareholder claims was a "fundamental corporate principle". This principle relied upon the popular view that creditors trade with the company on the understanding that:[74]
  a) there is an "equity cushion" that will not be removed during insolvency; and
  b) creditors price their loans to the company on the basis that they will receive priority over equity claims.
- The difficulty and complication that would be imposed on insolvency administrators in adjudicating claims if shareholders were permitted to rank alongside creditors.
- Shareholders undertake investment with knowledge that it is a risk-

71 (2000), 15 C.B.R. (4th) 169 (Alta. Q.B.) at 22.
72 (2000), 15 C.B.R. (4th) 169 (Alta. Q.B.) at 23.
73 (2000), 15 C.B.R. (4th) 169 (Alta. Q.B.) at 29ff.
74 Although not cited in the decision, this rationale is consistent with the thesis proposed by Slain & Kripke.

> ier activity than providing credit and should therefore bear the risk of business failure. In this case, the shareholder undertook the takeover bid without a full due diligence process and therefore should have appreciated the risk of purchasing the shares based on possibly incomplete information.

Her Honour also approved generally of the approach taken by U.S. courts on the subordination of shareholder claims.[75] The U.S. position on subordination is explained below.

Re Blue Range Resource Corp., was followed soon after in *National Bank of Canada v. Merit Energy Ltd.*[76] That case concerned an application for damages pursuant to a statutory cause of action for misrepresentation in the prospectus. The court refused the claim and stated:

> It is true these shareholders are using statutory provisions to make their claims in damages or rescission rather than the tort basis used in *Re: Blue Range Resource Corp*, but in substance they remain shareholder claims for the return of an equity investment. The right to a return of this equity investment must be limited by the basic common law principle that shareholders rank after creditors in respect of any return of their equity investment.

The resistance to allowing shareholder damages claims to rank alongside those of general unsecured creditors is consistent with the view taken in corporate reorganisation cases (under the CCAA) that shareholders whose interests are underwater should not be permitted to hinder the reorganisation.[77]

In the United States, prior to the enactment of a statutory subordination rule in 1978, there was some uncertainty about the admissibility of claims by allegedly defrauded shareholders in insolvency. A number of early decisions prohibited shareholders standing alongside creditors in corporate insolvencies

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75 (2000), 15 C.B.R. (4th) 169 (Alta. Q.B.) at 54.

76 (2001), 28 C.B.R. (4th) 228 (Alta. Q.B.), affirmed (2002), 2002 CarswellAlta 23 (C.A.).

77 See *Cadillac Fairview Inc., Re* (1995), 1995 CarswellOnt 2488 (Ont. Gen. Div. [Commercial List]) at 8 per Farley J.; *Canadian Airlines Corp., Re* (2000), 9 B.L.R. (3d) 41 (Alta. Q.B.), leave to appeal refused (2000), 2000 CarswellAlta 919 (Alta. C.A. [In Chambers]), affirmed (2000), 2000 CarswellAlta 1556 (Alta. C.A.), leave to appeal refused (2001), 2001 CarswellAlta 888 (S.C.C.) at 76 [B.L.R.] per Paperny J; *Loewen Group Inc., Re* (2001), 22 B.L.R. (3d) 134 (Ont. S.C.J. [Commercial List]) at 9 per Farley J.; *Stelco Inc., Re* (2006), 18 C.B.R. (5th) 173 (Ont. S.C.J. [Commercial List]) at 11 per Farley J. For an application of these principles under the BIA see: *Fiber Connections Inc. v. SVCM Capital Ltd.* (2005), 5 B.L.R. (4th) 271 (Ont. S.C.J.), leave to appeal allowed (2005), 2005 CarswellOnt 1834 (Ont. C.A. [In Chambers]).

on the basis of equitable estoppel.[78] However, these decisions were marginalised by the subsequent refusal by the U.S. Supreme Court in *Oppenheimer v. Harriman National Bank and Trust Co.*[79] to subordinate the claims of shareholders in a bank who were induced to purchase shares on the basis of misrepresentation. In the four decades after *Oppenheimer*, the issue of shareholder subordination of misrepresentation damages claims was only rarely discussed by U.S. lower courts. However, the trenchant argument by Professors Slain and Kripke in favour of subordination in the early 1970's contributed significantly to a legislative solution to mandate (via s. 510(b)) blanket subordination of shareholder rescission claims arising out of the purchase or sale of securities.

Having examined traditional doctrinal support for subordination of shareholder damages claims in insolvency, it is now appropriate to discuss the operation of statutory subordination provisions.

III. STATUTORY SUBORDINATION PRINCIPLES IN AUSTRALIA AND THE US

This part of the paper offers two perspectives on the role of shareholder claims in insolvency that are diametrically opposed. One perspective, represented by the landmark judicial interpretation of s. 563A of the *Corporations Act 2001* (Cth) in *Sons of Gwalia* in Australia, recognises limited subordination and facilitates shareholder parity with creditor claims in certain circumstances. The other contrasting perspective, represented by s. 510(b) of the *Bankruptcy Code* in the U.S., endorses blanket subordination which eschews the equal treatment of shareholder and creditor claims in insolvency. The enactment of the Fair Fund provisions, discussed below, raises interesting questions on whether it is symbolic of a retreat from the blunt instrument of blanket shareholder subordination.

This section examines the policy rationale and operation of the relevant statutory provisions in both jurisdictions. It contrasts the different emphasis on the legal treatment of defrauded shareholders claims in insolvency and highlights the tension in U.S. law on treatment of such investors with reference to the role and operation of the Fair Funds for investors provision.

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78 See *Re Racine Auto Tire Co*, 290 F. 939 (7th Cir., 1923); *Re Recording Devices Co*, 1 F.2d 474 (S.D. Ohio, 1924), as discussed in John Slain and Homer Kripke, "The Interface between Securities Regulation and Bankruptcy-Allocating the Risk of Illegal Securities Issuance between Securityholders and the Issuer's Creditors" (1973) 48 New York University Law Review 261 at 281-284.

79 301 US 206 (1937).

1. Australian Perspective

As noted above, Australian corporate laws were largely adopted from the U.K. *Companies Act*, as amended. Indeed, the current subordination provision bears a close resemblance to the current subordination provision in the U.K. (s. 74(2)(f)). Similarly, as noted above in Pt I, the leading cases on the treatment of shareholder claims were British until the High Court's decision in *Webb* in 1993. It is therefore not surprising that the current Australian subordination provision (s. 563A of the *Corporations Act 2001* (Cth)) did not receive detailed consideration until the triology of decisions in the *Sons of Gwalia* litigation starting in 2005, culminating in the decision by the High Court of Australia.[80]

Sections 533 and 536A are the key statutory provisions under the *Corporations Act 2001* (Cth) which underpins proof and ranking of claims in a winding up.[81] The former provides that in every winding up, all debts payable by the company (present or future, certain or contingent) are admissible to proof against the company. Section 563A, concerned with the ranking of claims, provides:

> Payment of a debt owed by a company to a person in the person's capacity as a member of the company, whether by way of dividends, profits or otherwise, is to be postponed until all debts owed to, or claims made by, persons otherwise than as members of the company have been satisfied.

As is readily apparent from the text of s. 563A, creditors are offered protection by enshrining the rule that shareholder claims against the company are to be subordinated to creditors' claims in the circumstances stipulated above. The problem, however, is that the meaning of the phrase 'in the person's capacity as a member' is not readily apparent and gives rise to a contestable interpretation. The key issue arising from this statutory provision is whether a defrauded shareholder can be classed as a creditor and consequently have their damages claim against the company rank equally with ordinary unsecured creditors? That was the central issue which fell for determination in the *Sons of Gwalia* litigation. Before discussing the High Court's affirmation of a legislative policy

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80 *Sons of Gwalia Ltd. v. Margaretic* (2005), 55 ACSR 365, [2005] FCA 1306; On appeal to the Full Federal Court, *Sons of Gwalia Ltd (subject to deed of company arrangement) v Margaretic* (2006), 56 ACSR 585, [2006] FCAFC 17; On appeal to the High Court, *Sons of Gwalia Ltd v Margaretic* (2007), 232 ALR 232 [2007] HCA 1.

81 It should be noted that although these provisions deal with priorities in a liquidation, they were adopted as a matter of course into formal debt restructuring proposals under the voluntary administration regime.

of limited shareholder subordination and the reasons underpinning this landmark decision, it pays to examine the policy objectives of s. 563A.

(i) Policy Objectives: s. 563A

Unlike the relatively clear articulation of legislative policy on blanket shareholder subordination in the U.S., discussed below, Justice Gummow concluded in *Sons of Gwalia* that Australian subordination law does not manifest any clear legislative policy, nor does it evidence any close legislative consideration of the ends sought to be achieved.[82] The High Court of Australia, consequently, found itself in unchartered waters in determining parliament's intention on the allocation of risk between shareholders and creditors and the priorities between them upon insolvency.

However, notwithstanding this lacuna in our law, the High Court majority in *Sons of Gwalia* considered the legislative text and history of s. 563A and the role of investor protection laws before declaring that the Commonwealth parliament had, whether deliberately or not, redefined and elevated shareholders rights in insolvency.

Of the seven Justices, three (Gleeson CJ, Kirby and Callinan JJ.) paid ıttention to the modern trend towards enhanced investor protection in the contemporary Australian corporate landscape and the competing policy issues ırising from the treatment of shareholder and creditor claims in insolvency. The udgment of Gleeson C.J. recognised the intersection between the rights of shareholders and creditors in insolvency and observed that modern legislation:

> has extended greatly the scope for "shareholder claims" against corporations, with consequences for ordinary creditors who may find themselves, in an insolvency, proving in competition with members now armed with statutory rights.[83]

ıfore significantly, the Chief Justice was alive to the resultant policy issues and the tensions that were caused by such competing interests, but was content to ave it to parliament to resolve the following issues identified by his Honour:

> On the one hand, extending the range of claims by shareholders is likely to be at the expense of ordinary creditors. The spectre of insolvency stands behind corporate regulation. Legislation that confers rights of damages upon shareholders necessarily increases the number of potential creditors in a winding up. Such an increase normally will be at the expense of those who previously would have shared in the available assets. On the other hand, since the need for protection of investor often arises only in the event of insolvency, *such protec-*

82 *Sons of Gwalia* (2007), 232 ALR 232, 246-7 (42).
Sons of Gwalia (2007), 232 ALR 232, 240 (18).

> *tion may be illusory* if the claims of those who are given the apparent benefit of the protection are subordinated to the claims of ordinary creditors.[84] (emphasis added)

As the passage above demonstrates, the Chief Justice saw the need for legislative clarification regarding where the line should be drawn to accommodate competing shareholder and creditor interests in insolvencies. In his Honour's view, s 563A did not provide for a policy of blanket subordination, where all member claims must be deferred to non-member creditors in insolvency.

Chief Justice Glesson held that, compared with s. 510(b) of the *Bankruptcy Code* (U.S.), discussed below, the Australian statutory provision in s. 563A 'rejects a general policy' that shareholders rank last in insolvencies. His Honour held:[85]

> On the contrary, by distinguishing between debts owed to a member in the capacity as a member and debts owed to a member otherwise than in such a capacity, it rejects such a general policy [of 'members come last']. If there ought to be such a rule, it is not to be found in s 563A.

This may be contrasted with the common law position in Canada (outlined above), where numerous decisions have stated that shareholders should claim below creditors on the basis of public policy.

(ii) Operation of s. 563A

The litigation in *Sons of Gwalia* arose from a shareholder's claim of compensation for damages for harm suffered as a result of breach of particular statutory norms of behaviour by an insolvent company placed under voluntary administration.[86] Relying on s. 563A,[87] the administrator rejected the shareholder's claim, arguing that the section operated to defer the recovery of debts owed to "members in their capacity as members" to follow the payment of unsecured creditors. In this way, the scope, interpretation and application of s. 563A came under the judicial spotlight in the High Court. The discussion below

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84 Ibid.

85 *Sons of Gwalia* (2007), 232 ALR 232, 240-1 (19).

86 Administrators were appointed pursuant to s. 436A of the *Corporations Act 2001* (Cth).

87 Section 563A, ordinarily concerned with ranking of claims in a winding up, was incorporated into the company's deed of company arrangement under Australia's corporate rescue process (known as voluntary administration) and assumed relevance in this context.

highlights the facts and reasoning in *Sons of Gwalia*,[88] before considering implications for law reform and future directions for Australian insolvency law in Part III.

Mr Margaretic, a transferee shareholder, lodged a proof of debt for damages with the administrator of Sons of Gwalia Ltd, a gold mining company listed on the Australian Stock Exchange (ASX). The damages claim was based upon alleged misleading or deceptive conduct[89] by the company's officers and the company's failure to comply with continuous disclosure obligations,[90] resulting in the shareholder's shares becoming worthless.

The shareholder's loss and claim arose in the following context. Two weeks before the collapse of Sons of Gwalia Ltd., Mr. Margaretic purchased 20,000 fully paid ordinary shares in the company's capital via the ASX at a cost of $26,200. The precarious financial position of Sons of Gwalia Ltd was unknown to him. Mr. Margaretic alleged that, in breach of the ASX Listing Rules and the Corporations Act, Sons of Gwalia Ltd. had failed to notify the ASX and the market that its gold reserves were insufficient to meet its hedge delivery contracts and that it could not continue as a going concern. As a victim of the company's misleading and deceptive conduct, Mr. Margeretic claimed as compensation the difference between the cost of his shares and their value (nil). Upon rejection of the shareholder's claim by the company's administrator, the administrator sought court declarations that, inter alia, Mr Margeretic's claim was subordinated by s. 563A.

The Federal Court,[91] the Full Federal Court[92] and six of the seven High Court justices emphatically rejected the administrator's claim on the basis that Mr. Margaretic was not seeking damages in the capacity 'as a member'.[93] Instead, the majority opined that the consumer statutory protection provisions Mr. Margaretic relied upon to formulate his claim are open to any person that suffers loss as a result of misleading or deceptive conduct. It followed, therefore, that the subordination provision in s. 563A had no role to play in the circumstances of this case and that shareholders in Mr Margaretic's position can be elevated to rank equally with ordinary unsecured creditors. The following ex-

88 For detailed analysis of the decision, see Anil Hargovan and Jason Harris, "The Shifting Balance of Shareholder Interests in Insolvency: Evolution or Revolution?" (2007) 31(2) Melbourne University Law Review (forthcoming).

89 Statutory provisions prohibiting misleading and deceptive conduct are provided for in s. 1041H of the *Corporations Act 2001* (Cth); s. 12DA of the *Australian Securities and Investment Commission Act 2001* (Cth) and s. 52 of the *Trade Practices Act 1974* (Cth). Mr Margaretic relied on all of these consumer based statutory protective provisions.

90 Section 674 of the *Corporations Act 2001* (Cth).

91 *Sons of Gwalia Ltd. v. Margaretic* (2005), 55 ACSR 365, [2005] FCA 1306.

92 *Sons of Gwalia Ltd. (subject to deed of company arrangement) v Margaretic* (2006), 56 ACSR 585, [2006] FCAFC 17.

93 *Sons of Gwalia Ltd. v. Margaretic* (2007), 232 ALR 232; [2007] HCA 1.

tract from Justice Hayne's judgment encapsulates the majority's reasoning in the High Court: [94]

> . . . the obligation which Mr Margaretic seeks to enforce is not an obligation which the 2001 Act creates in favour of a company's members. The obligation Mr Margaretic seeks to enforce, in so far as it is based in statutory causes of action, is rooted in the company's contravention of the prohibition against engaging in misleading or deceptive conduct and the company's liability to suffer an order for damages or other relief at the suit of *any* person who has suffered, or is likely to suffer, loss and damage as a result of the contravention . . . Those claims are not claims 'owed by a company to a person in the person's capacity as a member of the company'. For these reasons, s 563A does not apply to the claim made by Mr Margaretic.

Primarily for these reasons, based on the nature of the shareholder's claim for damages, the High Court majority concluded that shareholders claim was outside the ambit of the subordination provision in s. 563A. This landmark decision effectively gives defrauded or misled Australian shareholders the green light to litigate against companies for such wrongful conduct and, significantly, to rank equally with ordinary claims should their claim succeed.

The distributive equality in Australian insolvency law mimics the U.S. treatment of subordination claims prior to legislative reforms in 1978, as discussed earlier. The current U.S. position, with dents in its 'shareholders come last' principle is discussed below.

2. U.S. Perspective[95]

(i) Policy Objectives: s. 510(b)

The common law's refusal to subordinate shareholder claims in insolvency, discussed earlier, was overturned by Congress with the introduction of s. 510(b) of the *Bankruptcy Code* in 1978. This enactment ended the era of defrauded shareholder/unsecured creditor distributive equality,[96] discussed ear-

94 *Sons of Gwalia* (2007), 232 ALR 232, [2007] HCA 1 at 206.

95 For a fuller discussion on the origins and operation of s. 510(b), see Anil Hargovan and Jason Harris, "Sons of Gwalia and statutory debt subordination: An appraisal of the North American experience" (2007) 20 Australian Journal of Corporate Law 265. See also Janis Sarra, "From Subordination to Parity: An International Comparison of Securities Law Claims in Insolvency Proceedings" (2007) 16 International Insolvency Review Pt II A, B.

96 Marvin Sprouse III, "A Collision of Fairness: Sarbanes-Oxley and S 510(b) of the Bankruptcy Code" [2005] American Bankruptcy Institute Journal (available at http://images.jw.com/com/publications/528.pdf).

lier in Part 1. Founded on Slain and Kripke's 'compelling'[97] theory of risk allocation, which effectively precludes a defrauded shareholder's claim for damages from enjoying a higher priority status from the debtor's estate, this provision states that:

> [A] claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, [or] for damages arising from the purchase or sale of such security . . . shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claims has the same priority as common stock.

Courts have routinely acknowledged the adoption by Congress of Slain and Kripke's theory of risk allocation, discussed earlier, as exemplified by the following passage from the leading decision of the United States Court of Appeals for the 3rd Circuit in *Re Telegroup Inc*:[98]

> Section 510(b) . . . represents a Congressional judgment that, as between shareholders and general unsecured creditors, it is shareholders who should bear the risk of illegality in the issuance of stock in the event the issuer enters bankruptcy . . .Congress enacted section 510(b) to prevent disappointed shareholders from recovering their investment loss by using fraud and other securities claims to bootstrap their way to parity with general unsecured creditors in a bankruptcy proceeding.

(ii) Operation of s. 510(b)

Until recent judicial developments, discussed below, U.S. courts have consistently limited the operation of s. 510(b) to claims alleging fraud in the inducement to *purchase or sell* a debtor's securities. Early cases limited the scope of s. 510(b) to claims directly "arising from" a purchase or sale of a security.[99] A literal interpretation of the statute sustains this result. Traditionally, this meant that shareholder claims based on post-issuance conduct did not fall within the ambit of s. 510(b).

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97 *Re Geneva Steel Co.*, 281 F.3d 1173 (10th Cir 2002) at 1177.

98 281 F 3d 133 (3rd Cir 2002) at 141-142. For recent judicial pronouncements of a similar nature, see *Re Med Diversified Inc.*, 461 F. 3d 251 (2nd Circ, 2006); *Re American Wagering Inc.*, 465 F.3d 1048 (9th Circ, 2006).

99 For example, *Re Amarex Inc.*, 78 B.R. 605 at 609 (Bankr. W.D. Okla. 1987): "The legislative history expressly focuses on the initial illegality and thus the automatic subordination should extend no farther." See also the later decision in *Re Montgomery Ward Holding Corp*, 272 B.R 836 at 842 (Bank.D.Del 2001): "[T]he plain language of the statute limits automatic subordination to claims that directly concern the stock transaction itself."

However, despite the existence of s. 510(b) for almost three decades, the courts are still grappling with the language and policy objectives of the subordination principle.[100] Judicial tension in the interpretation and proper scope of s. 510(b) is best exemplified in the narrower decisions in *Re Amarex Inc*[101], *Re Angeles Corp*[102] and *Re Montgomery Ward Holding Corp*[103] (rejecting subordination claims based on post-issuance wrongful conduct) and the wider decisions in *Re Telegroup Inc*[104]*and Re Geneva Steel*[105] accepting such claims.

(iii) A robust approach

In more recent times, there has been a paradigm shift and trend towards a broader interpretation of s. 510(b). This broader interpretation has been most prominently stated by the U.S. Court of Appeals for the 3rd Circuit[106] in *Telegroup* and by the Court of Appeals for the 10th Circuit in *Geneva Steel*.[107] These decisions capture post-issuance fraud claims within s. 510(b) and therefore represent a paradigm shift from the cases discussed above and the traditional understanding of the meaning of the words in that section.

The Court of Appeal in *Telegroup* fortified its conclusion by relying on a variety of official reports and, significantly, the Slain and Kripke article with its emphasis on the theory of risk allocation between creditors and shareholders discussed earlier. The court opined that the legislative history, by adopting the Slain and Kripke argument, sheds light on the policies animating s. 510(b).[108] Although Slain and Kripke's article was primarily concerned with actionable conduct occurring in the issuance of the debtor's securities, as opposed to post-issuance conduct,[109] the court in *Telegroup* stressed that the examples raised in

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100 See further, M Schmid, 'A Congressional Montage of Two Systems of Law-Mandatory Subordination Under the Code' (2005) 13 American Bankruptcy Institute Law Review 361.

101 78 B.R. 605 (W.D. Okla. 1987).

102 177 B.R 920 (Bankr. C.D. Cal. 1995).

103 272 B.R. 836 (Bankr. D. Del. 2001).

104 281 F 3d 133 (3rd Cir 2002).

105 281 F.3d 1173 (10th Cir 2002).

106 It should be noted that the U.S. Court of Appeals for the 3rd Circuit includes the influential state of Delaware.

107 There is also a wealth of district court and bankruptcy court decisions across all circuits that supports the broad interpretation of s. 510(b): see for example *Re Pre-Press Graphics Co Inc*, 307 B.R. 65 (ND Ill 2004); *Re WorldCom Inc*, 329 B.R. 10 (SDNY 2005); *Re Enron Corp*, 341 BR 141 (SDNY 2006).

108 281 F. 3d 133 (3rd Cir 2002) at 140.

109 *Re Geneva Steel Co* 281 F.3d 1173 (10th Cir 2002) at 1179: ". . .it is . . .true that neither Congress nor Slain and Kripke discussed or even mentioned fraudulent retention claims."

the article were "illustrative, not exhaustive" of claims that must be subordinated.[110] From a policy standpoint, *Telegroup* held:[111]

> Congress intended to prevent disaffected equity investors from recouping their investment losses in parity with general unsecured creditors in the event of bankruptcy . . . because [the] claimants retained the right to participate in corporate profits if Telegroup succeeded, we believe that section 510(b) prevents them from using their breach of contract claim to recover the value of their equity investment in parity with general unsecured creditors.

The court in *Telegroup* reasoned it would be senseless to allow shareholders to gain parity with unsecured creditors simply because their claims were predicated on post-issuance conduct. According to *Telegroup*, to hold otherwise would offend Congressional policy of preventing shareholders from using fraud claims to "bootstrap their way to gain parity with, or preference over, general unsecured creditors".[112]

Telegroup has received a mixed judicial reception.[113] Although the balance of judicial authority supports this broader and stricter interpretation, arguably this prevailing view represents a paradigm shift from the architect's original intention[114] and a 'confusing' area of the law.[115]

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110 281 F 3d 133 (3rd Cir 2002) at 140. Cf R Stark, "Reexamining the subordination of investor fraud claims in bankruptcy" (1998) 72 American Bankruptcy Law Journal 497 at 508: "[T]he House Report's reference to rescission claims suggests that Congress, like Slain and Kripke, did not focus on fraud in the retention claims when drafting section 510(b) This seems correct based on the plain language of the section . . .".

111 281 F 3d 133 (3rd Cir 2002) at 142.

112 281 F. 3d 133 (3rd Cir 2002) at 141. Similarly, the Court of Appeals for the 10th Circuit in *Geneva Steel* applied a broad interpretation of the term 'arising from' and subordinated the claims of a bondholder arising from the debtor's post-investment fraud which induced the bondholder to retain, rather than sell, its securities.

113 See, for examples of dissent, within the 3rd Circuit: *Re International Wireless Communications Holdings Inc*. 68 Fed. Appx. 275 (3d Cir. 2003); *Re Alta+Cast LLC*. 301 B.R. 150 (Bankr. D. Del. 2003). The decision has however been followed in US Court of Appeals for the 9th Circuit (*Re American Wagering Inc* 465 F.3d 1048 (9th Cir. Nev. 2006)) and by lowers courts in the 2nd Circuit (*Re Med Diversified Inc*. 461 F.3d 251 (2d Cir. N.Y. 2006)), the 7th Circuit (*Re Pre-Press Graphics Co Inc*, 307 B.R. 65 (ND Ill 2004)) and the 11th Circuit (*Re Vista Eyecare Inc*, 283 B.R. 613 (Bankr. N.D. Ga. 2002)).

114 R Stark, 'Reexamining the subordination of investor fraud claims in bankruptcy' (1998) 72 American Bankruptcy Law Journal 497.

115 M Schmid, "A Congressional Montage of Two Systems of Law-Mandatory Subordination Under the Code" (2005) 13 American Bankruptcy Institute Law Review 361.

(iv) Fair Funds for Investors

The recent enactment of a 'particularly novel provision'[116] in the *Sarbanes-Oxley Act* of 2002, the Fair Fund provision for injured investors, and its aggressive implementation by the SEC,[117] is further illustration of the confusion in U.S. bankruptcy policy. Prior to the enactment of these reforms, only disgorgement could be returned to injured investors. All civil penalties obtained by the SEC in securities enforcement were deposited in the general fund of the U.S. Treasury and could not be returned to investors. However, as consequence of these reforms in 2002, the SEC can now increase the amount of money returned to harmed investors by allowing financial penalties paid by wrongdoers to be included in the distributions. The fair funds for investors provision under the *Sarbanes Oxley Act* provides:

> 308(a) Civil Penalties Added to Disgorgement Funds for the Relief of Victims.
>
> If in any judicial or administrative action brought by the Commission under the securities laws (as such term is defined in section 3(a)(47) of the Securities Exchange Act of 1934) the Commission obtains an order requiring disgorgement against any person for a violation of such laws or the rules or regulations thereunder, or such person agrees in settlement of any such action to such disgorgement, and the Commission also obtains pursuant to such laws a civil penalty against such person, the amount of such civil penalty shall, on the motion or at the direction of the Commission, be added to and become part of the disgorgement fund for the benefit of the victims of such violation.

This safety net provision for injured investors under the *Sarbanes Oxley Act*, aimed at maximising restitution, appears to undermine the strong policy foundations of U.S. subordination laws in the following way. The injured investor of an entity subject to both the *Bankruptcy Code* and *Sarbanes-Oxley*, as noted by Sprouse, is "potentially at the intersection of conflicting statutory schemes.".[118] A collision of interests is apparent when an injured investor whose

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116 Statement of Stephen Cutler, Director, Division of Enforcement of the SEC, made at Congressional hearing. See "Its Only Fair: Returning Money to Defrauded Investors" U.S. House of Representatives, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises Committee on Financial Services, 26 February 2003, Serial No. 108-4 (http://commdocs.house.gov/committees/bank/hba86851.000/hba86).

117 See references in n 6. For a critical analysis on the performance of the SEC under these reforms, see James Cox and Randall Thomas, "SEC Enforcement Heuristics: An Empirical Inquiry" (2003) 53 Duke Law Journal 737; SEC, Report Pursuant to Section 308(c) of the Sarbanes -Oxley Act of 2002, 2003.

118 Marvin Sprouse III, "A Collision of Fairness: Sarbanes-Oxley and S 510(b) of the Bankruptcy Code" [2005] American Bankruptcy Institute Journal (available at http://images.jw.com/com/publications/528.pdf).

claims must be subordinated pursuant to s. 510(b) of the *Bankruptcy Code* may also be qualified for a distribution to the Fair Funds for Investors provision of *Sarbanes-Oxley*.

Whilst there is an obvious tension between the fair funds provisions and the subordination of claims under s. 510(b) of the *Bankruptcy Code*,[119] the relatively few judicial decisions on this issue have decided that Congress has made a conscious choice, in limited circumstances where the fair funds provisions apply, to prefer shareholder protection over bankruptcy priorities.[120] It remains to be seen whether this marks a new chapter and direction, amounting to a detour, in U.S. subordination laws.[121]

IV. FUTURE DIRECTIONS

In Parts II and III of this paper we discussed the manner in which the traditional rationale for the subordination of shareholder claims in insolvency has been brought into question by recent Australian case law and statutory developments in the U.S. In this Part we attempt to outline where the treatment of shareholder misrepresentation claims in Australia, U.S. and Canada may be headed in the future.

In Australia, the Corporations and Markets Advisory Committee (CAMAC) has been given the task of reviewing current laws to determine how best to address the tension between securities law claims and the system of priorities in insolvency. CAMAC has been asked to report on the following issues:

1. Should shareholders who acquired shares as a result of misleading conduct by a company prior to its insolvency be able to participate in an insolvency proceeding as an unsecured creditor for any debt that may arise out of that misleading conduct?
2. If so, are there any reforms to the statutory scheme that would facilitate the efficient administration of insolvency proceedings in the presence of such claims?

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119 See Z Christensen, "The Fair Funds for Investors Provision of Sarbanes-Oxley: Is it Unfair to the Creditors of a Bankrupt Debtor?" [2005] University of Illinois Law Review 339.

120 Judicial decisions are discussed in Christensen, above note 119 and in Sprouse, *supra*, note 118. Sprouse notes that thus far, the courts have recognised, but not resolved, the dissonances between Sarbanes-Oxley and the Bankruptcy Code.

121 Douglas Henry, "Subordinating Subordination: WorldCom and the Effect of Sarbanes-Oxley's Fair Funds Provision on Distributions in Bankruptcy" (2004) 21 Emory Bankruptcy Developments Journal 259 at 299 observes that the Fair Funds Provisions "signals the beginning of a new age of [U.S.] bankruptcy law."

3. If not, are there any reforms to the statutory scheme that would better protect shareholders from the risk that they may acquire shares on the basis of misleading information?

In Part II we argued that legitimate claims can be made in favour of a policy of limited shareholder subordination in insolvency. High levels of share ownership in Australia strengthen the need for investor protection. In recent years, share ownership in Australia has increased dramatically with 46% of the Australian population owning (directly and indirectly) shares and compulsory pension funds (largely invested in shares) exceeding $1 trillion.[122] This heightened level of activity creates a political imperative to encourage confidence in the equity markets. The drive to enhance investor rights and shareholder activism has also been increasing in Australia, with securities class actions becoming more prevalent[123] and investor advocacy bodies such as the Australian Shareholders Association receiving extensive media coverage. In addition to the increasing importance of share ownership to Australian households, it should be noted that 2007 is an election year for the federal government, making it unlikely that any change to overturn the *Sons of Gwalia* decision will be made soon.

However, that is not to say that the CAMAC investigation will not advocate some change to the law. At the same time that the equity markets have been booming, the corporate debt market in Australia has also been increasing, and there have already been loud calls from the banking sector to amend the *Corporations Act* to overturn the *Gwalia* decision. It seems likely that some form of compromise may be reached that will placate corporate financiers whilst not alienating shareholders. As noted above, a system of limited subordination could be introduced. Alternatively, a provision similar to the U.S. Fair Funds for Investors provision could be introduced, particularly with recent pressure being placed on ASIC to take a more pro-active stance in pursuing litigation in the wake of numerous corporate collapses.[124]

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122 Australian Prudential Regulatory Authority, media release, 27 June 2007 (http://www.apra.gov.au/media-releases/07_22.cfm).

123 At the time of writing, there were securities class actions pending against some of Australia's largest companies including Telstra (telecommunications), Aristocrat (gaming) and Multiplex (construction). See, for example, *P Dawson Nominees Pty Ltd v Multiplex Ltd* [2007] FCA 1061 (19 July 2007). For a list of current securities class actions in Australia see http://www.delisted.com.au.

124 In the last 2 years a property downturn has led to the collapse of several major property development companies, with the most notable example being the Westpoint group with close to $1 billion in development projects. Thousands of investors, mostly self-funded retirees, lost their money when the company was unable to complete several projects, and was unable to sell all of the apartments in its completed projects. ASIC has attracted criticism in the media and in parliament for failing to "prevent" the group's collapse, and angry investors have protested outside

In the United States, the Fair Fund for Investors provision allowing for penalties ordered in civil litigation involving the SEC to be distributed to defrauded investors has been in operation for 5 years, and has distributed over U.S. $1.8 billion. Whilst most of these funds have been distributed in non-bankruptcy cases, 2 significant cases have involved distributions to shareholders of insolvent companies, namely Enron and Worldcom.[125] The obvious tension between the fair fund provision and the ordinarily subordinated position of shareholders has attracted little criticism in the U.S. Indeed, it seems that the only criticism made of the provision is the delay caused by the complexity of identifying and distributing recovered funds to investors. The SEC has acknowledged its problems in distributing the funds quickly and has announced plans to make its internal processes more efficient. Perhaps the reason for the lack of criticism is that there have not been a large number of cases involving claims against insolvent companies.

Finally, in Canada the insolvency law reform process has been continuing for several years now.[126] Significant amendments were proposed by Bill C-55, which passed in 2005 (and thereby became Chapter 47 of the Statutes of Canada 2005), but was not proclaimed due to a change of government and concerns raised by the business community. Subsequent consultation led to further proposed changes in late 2006, both to the original amendments passed in C-47 and also new amendments arising out of the consultation process. These proposed changes have now been incorporated into Bill C-62 of 2007, which at the time of writing had been passed by the House of Commons and was being considered by the Senate.[127] These reforms cover a broad range of insolvency issues, however for present purposes the reforms propose the following changes to Canadian insolvency law to address shareholder claims in insolvency.

Firstly, the reforms propose to insert a new definition of equity claim and equity interest into the *Bankruptcy and Insolvency Act*.

> "equity claim" means a claim that is in respect of an equity interest, including a claim for, among others,
>
> (a) a dividend or similar payment,

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its offices and the offices of prominent government ministers. In the last 12 months a further 3 property development companies have also collapsed with close to $800 million outstanding. All 4 companies targeted retiree investors.

125 Of the US$750 million set aside for Worldcom defrauded investors, at 20 November 2006 only $150 million had actually been distributed: SEC Media Release 2006-179.

126 See the initial reports by *Joint Task Force on Business Insolvency Law Reform* (2002); *Standing Senate Committee on Banking, Trade and Commerce* (2003).

127 See further, Janis Sarra, "From Subordination to Parity: An International Comparison of Securities Law Claims in Insolvency Proceedings" (2007) 16 International Insolvency Review Pt II D.

(b) a return of capital,

(c) a redemption or retraction obligation,

(d) a monetary loss resulting from the ownership, purchase or sale of an equity interest or from the rescission, or, in Quebec, the annulment, of a purchase or sale of an equity interest, or

(e) contribution or indemnity in respect of a claim referred to in any of paragraphs (a) to (d).

"Equity interest" is defined broadly to include a share, warrant or option.

The Bill proposes to restrict the right of creditors holding "equity claims" by preventing them from voting on proposals under Pt III unless the court orders otherwise (ss. 54, 54.1). Furthermore, the Bill proposes to defer the ability of creditors to receive a dividend in respect of an equity claim until all claims that are not equity claims have been satisfied (s. 140.1). Lastly, any proposal under Pt III that involves equity claims must not by approved by the court unless it provides for the full payment of non-equity claims before the payment of equity claims (s. 60(1.7)).

The Bill will amend the CCAA by inserting a new s. 22.1 which requires all creditors with equity claims to be constituted in the same class and to be prohibited from voting unless the court orders otherwise. Creditors with equity claims are also excluded from consideration of the requisite majority under s. 6 unless the court orders otherwise. The amendments to s 6(8) will also provide for the deferral of payments in respect of equity claims until after non-equity claims have been paid in full.

These reforms will introduce blanket subordination for equity claims in Canada in a manner that is even stricter than U.S. subordination laws. In addition, there is no proposal to introduce any exception for defrauded shareholders similar to the fair funds provision in the U.S. This should make Canada a more attractive jurisdiction in which to conduct large corporate reorganisations.[128]

128 The initiative to introduce statutory subordination came about due to fears that large corporate restructurings were being conducted in the US rather than Canada due to the absence of a statutory subordination rule. See *Joint Task Force on Business Insolvency Law Reform*, Final Report (2002) Sch. B at 32; *Standing Senate Committee on Banking, Trade and Commerce*, "Debtors and Creditors Sharing the Burden" (2003) at 159-160; S Towriss, "Through the Lens of Insolvency: Shareholder Equity in CCAA Restructurings" [2005] Annual Review of Insolvency Law 527 at 528.

V. CONCLUSION

There is an inherent tension involved in granting investors rights to enforce proper disclosure practices and compensatory remedies for breach of those disclosure requirements, on the one hand, with the subordination of debts owed to shareholders in insolvency. After all, it is during the company's insolvency that shareholders misled into buying into a failing company by inaccurate, or even fraudulent market disclosure practices will require protection as their investments will be lost by the company's insolvency.

The paper has demonstrated that the interaction between insolvency law and investor protection laws, and the striking of the appropriate balance in respecting entitlements, lies at the centre of current law reform debate in Australia. At the time of writing, *Sons of Gwalia* now stands as authority for the proposition that shareholder claims for compensation for the loss of the value of their shares, in circumstances of being defrauded or misled similar to Mr. Margaretic, do not fall into the category of subordinated payments (such as dividends or profits) which rank behind creditor payments. Subject to proving reliance and causation, misled shareholders will be entitled to a pro-rata distribution with all other unsecured creditors.

The position we endorse, in addressing the future shape of Australia's insolvency law, is a slight variant of the High Court decision in *Sons of Gwalia*. Between the two extremes of blanket subordination and total shareholder parity discussed earlier in Part II, we see a viable middle path which adopts a more nuanced approach to subordination that combines features of both policy options.

We advocate the need for a targeted, and consequently limited, approach to shareholder subordination with a distinction drawn in the legal treatment of newly defrauded shareholders, as opposed to existing shareholders. In an attempt to strike an appropriate balance between encouraging investor confidence in the equity market and allaying some of the concerns of the debt capital market, we favour the formulation of a statutory rule that would subordinate existing shareholders from claiming misrepresentation or fraud damages in insolvency, but would allow new 'outside' shareholders to maintain such claims for reasons discussed earlier in Part III. Such an approach draws a legitimate line between two clearly different types of risks. We agree that it is unfair for creditors to underwrite the shareholders' speculative investment risk. However, for reasons advanced earlier in Part III, we disagree with the use of blanket shareholder subordination as a blunt instrument in instances where shareholders have been misled or defrauded when purchasing their shares. From an Australian perspective, blanket shareholder subordination would frustrate the raison d'etre of consumer protection laws and ignore Australia's modern corporate milieu

with its increased focus on investor protection,[129] private remedies and compensatory entitlements.[130]

While Australia and the U.S. examine ways to enforce shareholder rights in insolvency, Canada is proposing to move in the opposite direction. In our view, neither approach is necessarily superior; there is no "end of history" in sight for subordination principles. Ultimately, the choice of priority is a political one, not a legal one.

129 For judicial observation of substantial legal changes relating to corporate responsibility over the last century, see *Re Pyramid Building Society (in liq)* (1991) 6 ACSR 405, 408-9 (Vincent J).

130 For private enforcement of the *Corporations Act 2001* (Cth), see for example ss. 729 (allows investor to sue for damages for defective disclosure documents during corporate fundraising), 674 (continuous disclosure obligation) 1317H, 1317HA (compensation orders may be made against a person for breach of, inter alia, 674), 10411 (allows an investor to sue both a corporation and/or a person involved in the contravention for damages for misleading or deceptive conduct in relation to financial services) 1324 (injunction and/or damages).

TAB B

TAB 1

Securities Act

R.S.O. 1990, CHAPTER S.5

Applications to court

128. (1) The Commission may apply to the Superior Court of Justice for a declaration that a person or company has not complied with or is not complying with Ontario securities law. 1994, c. 11, s. 375; 2006, c. 19, Sched. C, s. 1 (1).

Prior hearing not required

(2) The Commission is not required, before making an application under subsection (1), to hold a hearing to determine whether the person or company has not complied with or is not complying with Ontario securities law. 1994, c. 11, s. 375.

Remedial powers of court

(3) If the court makes a declaration under subsection (1), the court may, despite the imposition of any penalty under section 122 and despite any order made by the Commission under section 127, make any order that the court considers appropriate against the person or company, including, without limiting the generality of the foregoing, one or more of the following orders:

1. An order that the person or company comply with Ontario securities law.

2. An order requiring the person or company to submit to a review by the Commission of his, her or its practices and procedures and to institute such changes as may be directed by the Commission.

3. An order directing that a release, report, preliminary prospectus, prospectus, return, financial statement, information circular, takeover bid circular, issuer bid circular, offering memorandum, proxy solicitation or any other document described in the order,

    i. be provided by the person or company to another person or company,

    ii. not be provided by the person or company to another person or company, or

    iii. be amended by the person or company to the extent that amendment is practicable.

4. An order rescinding any transaction entered into by the person or company relating to trading in securities including the issuance of securities.

5. An order requiring the issuance, cancellation, purchase, exchange or disposition of any securities by the person or company.

6. An order prohibiting the voting or exercise of any other right attaching to securities by the person or company.

7. An order prohibiting the person from acting as officer or director or prohibiting the person or company from acting as promoter of any market participant permanently or for such period as is specified in the order.

8. An order appointing officers and directors in place of or in addition to all or any of the officers and directors of the company then in office.

9. An order directing the person or company to purchase securities of a security holder.

10. An order directing the person or company to repay to a security holder any part of the money paid by the security holder for securities.

11. An order requiring the person or company to produce to the court or an interested person financial statements in the form required by Ontario securities law, or an accounting in such other form as the court may determine.

12. An order directing rectification of the registers or other records of the company.

13. An order requiring the person or company to compensate or make restitution to an aggrieved person or company.

14. An order requiring the person or company to pay general or punitive damages to any other person or company.

15. An order requiring the person or company to disgorge to the Minister any amounts obtained as a result of the non-compliance with Ontario securities law.

16. An order requiring the person or company to rectify any past non-compliance with Ontario securities law to the extent that rectification is practicable. 1994, c. 11, s. 375.

Interim orders

(4) On an application under this section the court may make such interim orders as it considers appropriate. 1994, c. 11, s. 375.

IN THE MATTER OF THE *COMPANIES' CREDITORS ARRANGEMENT ACT*, R.S.C., 1985 c. C-36, AS AMENDED

AND IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF NELSON FINANCIAL GROUP LTD. Applicant

Court File No. 10-8630-00CL

ONTARIO
SUPERIOR COURT OF JUSTICE
(COMMERCIAL LIST)

FACTUM OF DOUGLAS TURNER, Q.C., IN HIS CAPACITY AS THE REPRESENTATIVE COUNSEL FOR NOTEHOLDERS

(Motion returnable October 18, 2010)

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