| | |
|---|---|
| COURT FILE NUMBER | 1601-11552 |
| COURT | COURT OF QUEEN'S BENCH OF ALBERTA |
| JUDICIAL CENTRE | CALGARY |
| APPLICANT | NATIONAL BANK OF CANADA IN ITS CAPACITY AS ADMINISTRATIVE AGENT UNDER THAT CERTAIN AMENDED AND RESTATED CREDIT AGREEMENT DATED JANUARY 15, 2016, AS AMENDED |
| RESPONDENT | TWIN BUTTE ENERGY LTD.<br>IN THE MATTER OF THE RECEIVERSHIP OF TWIN BUTTE ENERGY LTD. |
| PARTY FILING THIS DOCUMENT | FTI CONSULTING CANADA INC. in its capacity as Court-appointed Receiver of the current and future assets, undertakings and properties of TWIN BUTTE ENERGY LTD. |
| DOCUMENT | **BOOK OF AUTHORITIES OF THE RECEIVER RE: SUBORDINATION APPLICATION** |
| ADDRESS FOR SERVICE AND CONTACT INFORMATION OF PARTY FILING THIS DOCUMENT | Norton Rose Fulbright Canada LLP<br>3700, 400 Third Ave SW<br>Calgary, Alberta T2P 4H2<br><br>Phone: 403.267.8222<br>Fax: 403.264.5973<br><br>**Howard A. Gorman Q.C. / Aditya M. Badami**<br>File No. 01020497-0005<br>*Counsel for the Court-appointed Receiver*<br>*FTI Consulting Canada Inc.* |

# TABLE OF AUTHORITIES

1. *Bank of Montreal v. Dynex Petroleum Ltd*., [1997] 6 WWR 104, [1997] AJ No 341
2. *Air Canada, Re*, [2004] OJ No 1909, [2004] OTC 1169
3. *Rico Enterprises Ltd., Re*, [1994] BCWLD 726, [1994] BCJ No 3019
4. *Blue Range Resource Corp*., Re, 2000 ABQB 4
5. *National Bank of Canada v. Merit Energy Ltd*., 2001 ABQB 583

TAB 1

1997 CarswellAlta 209
Alberta Court of Queen's Bench

Bank of Montreal v. Dynex Petroleum Ltd.

1997 CarswellAlta 209, [1997] 6 W.W.R. 104, [1997] A.J. No. 341, 12 P.P.S.A.C. (2d) 183, 145 D.L.R. (4th) 499, 202 A.R. 331, 31 B.L.R. (2d) 44, 46 C.B.R. (3d) 36, 50 Alta. L.R. (3d) 44, 70 A.C.W.S. (3d) 217

# Bank of Montreal, Plaintiff and Dynex Petroleum Ltd., Alberta Energy Company Ltd., Ardmore Investments Ltd., Transcanada Pipelines Ltd., Amoco Canada Petroleum Ltd., Atcor Ltd., Crestar Energy Inc., Dana Distributors Ltd., Enchant Resources Ltd., Vimyview Ltd., Col-Syb Holdings Ltd., Hexam Holdings Ltd., Davids Investments Ltd., Edward W. Hadway, Estate of Harry Veiner, Victor Sopkiw, NancyOil & Gas Ltd., Staniloff Oil & Gas Ltd., Cory Oils Ltd., Doran Investments Ltd., Encor Energy Corporation Inc., Epic Resources Ltd., Kirriemuir Resources Ltd., Meridian Oil Inc., North Canadian Oils Limited, Odessa Natural Corporation, Precambrian Shield Resources Limited, Star Oil and Gas Ltd., Suncor Inc., D.S. Willness, Earl Gordon, Antelope Land Services Ltd., Brannigan Resources Canada (1992) Ltd., Jim Bruce Consultants, Saskatchewan Oil and Gas Corporation, Sask Oil Resources Inc., Landsea Oil & Gas Ltd., Intensity Resources Ltd., Deane Enterprises Ltd., Shell Canada Resources Ltd., Enron Oil Canada Ltd., and Channel Lake Petroleum Ltd., Defendants

Rooke J.

Judgment: April 4, 1997
Docket: Calgary 9301-08195, BK 039154

Counsel: *Richard B. Jones* and *Gordon S. Griffiths, Q.C.*, for Plaintiff Bank of Montreal.
*James C. Crawford, Q.C.*, for Defendants Enchant Resources Ltd. and D.S. Willness.
*Frank R. Dearlove* and *Scott H.D. Bower*, for Defendants Meridian Oil Inc. & Odessa Natural Corporation.
*Richard C. Dixon*, for Ernst & Young Inc.

Subject: Insolvency

APPLICATION for determination of priorities on bankruptcy.

***Rooke J.*:**

**I. Introduction**

1 The issue in this Decision, in its simplest form, is to determine the effect of the bankruptcy of a petroleum and natural gas company, Dynex Petroleum Ltd., then in receivership, on the competing interests of the secured real and personal property, duly registered and crystallized debenture holder, the Plaintiff, the Bank of Montreal (the "B of M"), as against certain overriding royalty and net profits interests of various Defendants (including the parties to this hearing, Enchant Resources Ltd. ("Enchant"), Meridian Oil Inc. ("Meridian"), Odessa Natural Corporation ("Odessa"), and D.S. Willness ("Willness")) (collectively the "ORRs"), granted by Dynex or its predecessors (collectively "Dynex") under petroleum and natural gas leases, when the B of M's debenture was subordinated to the interests of only partially registered ORRs.

**II. Executive Summary**

  

2 After considering all of the issues herein, as set out in these Reasons, I have concluded that the priorities between the B of M and the ORRs relate less to the status of these parties in the bankruptcy (as a secured creditor and unsecured creditors respectively, as I have found) than to the effect of the bankruptcy on the subordination. I have found that the subordination of the B of M to the ORRs survives the bankruptcy of Dynex, and that the ORRs are entitled to recover any of their loss in bankruptcy (that is not recovered from the Trustee) from the B of M.

**III. Simple Facts**

3 The simple facts necessary to have a proper appreciation of this Decision, by someone other than the parties, can be set out fairly succinctly utilizing the very helpful headnote of the Alberta Law Reports in the decision that I granted on some earlier questions between these parties: *Bank of Montreal v. Dynex Petroleum Ltd.* (1995), 39 Alta. L.R. (3d) 66 (Alta. Q.B.), flowing from oral reasons for decision granted December 19 and 20, 1995 (the "December 1995 Decision", on three separate specific issues, and a formal Order dated December 20, 1995.

4 Those simple facts, relying on the Alberta Law Reports headnote (with necessary changes), are as follows:

> [Dynex and its predecessors] had granted overriding royalty and net profit interests to certain third parties [ORRs] in respect of its oil and gas leases. Some time later, [Dynex] went to the [B of M] for financing, employing the oil and gas leases as security. [Dynex] gave a debenture [and other security documents including "General Assignments" under what is now Section 426 of the *Bank Act*, formerly Section 82 and later Section 177], and all of the documentation supporting the transaction stated that the [ORRs] interests were permitted encumbrances.... [Dynex] eventually defaulted on the loan and the [B of M] put it into receivership under the debenture [May 14, 1993]. A short time later [Petition - May 26, 1993 and Receiving Order May 27, 1993] [Dynex] went into bankruptcy. The [B of M] sued [Dynex, in bankruptcy] and the numerous [ORRs], seeking, as against the [ORRs], a declaration that the security granted by [Dynex] to the [B of M] ranked in priority to the [ORRs] in the context of bankruptcy. [In the hearings held in December, 1995] the [B of M] applied for a preliminary determination that the interest claimed by the [ORRs] were not interests in land. [Some of the ORRs] applied for summary judgment dismissing the action. [All of the parties to the application requested the Court to determine the priorities between the B of M and the ORRs after crystallization of the debenture security on May 14, 1993 and prior to the Bankruptcy Petition of May 26, 1993].

5 There are substantially more detailed facts than set out above within the December 1995 Decision and referred to in the legal briefs of the parties then, and in the within application, and as contained in numerous documents filed by the parties prior to the December 1995 Decision and in this application (the latter 2 volume binder set referred to as the "Document Record"). However no useful purpose would be served in these Reasons by setting out the facts in any greater detail at this point. Accordingly, I will not do so, except as may later be necessary to make the within Decision and provide these Reasons. Anyone wanting a more detailed analysis of the facts will have to look at the background material.

**IV. December 1995 Decision**

6 In the December 1995 Decision, I basically came to three conclusions, namely:

> (1) the ORRs interests, being granted "downstream" of leases, could not, as a matter of law, become interests in land, and, in the alternative, if that decision was incorrect in law, a trial of an issue would be necessary to determine whether, as a matter of fact, the documentation pertaining to the ORRs did create such an interest in land;
>
> (2) the priorities in bankruptcy could not be determined on the summary application, and therefore, summary judgment was denied; and
>
> (3) after crystallization of the debenture (and other related security), but before the bankruptcy, the B of M's interests were subordinated to the interests of the ORRs.

  

7 While the aforementioned three points constituted the substance of the December 1995 Decision of the Court, it is, once again, set out fairly succinctly, but in somewhat more detail, in the headnote of the Alberta Law Reports, which I adopt, with the necessary changes, for this purpose. The decision as therein stated is as follows (at 67):

> As a matter of law, a lessee of an oil and gas lease, which, as a *profit à prendre*, is itself an interest in land, obtained from a lessor, cannot pass on an interest in land. If it was permissible in law to have an interest in land downstream of a profit à prendre, then the language of the instrument creating the interest would have to reflect an intention to create an interest in land. Examination of such instrument[s] could not be made in a summary proceeding.
>
> The Statement of Claim referred to the parties' interest in the context of bankruptcy, while it was apparent that the defendants' motion referred to the parties' interest at a point in time after the appointment of a receiver, but prior to the bankruptcy. Clearly, therefore, there were triable issues in respect of the parties' interest after the bankruptcy, and summary judgment would not be available to determine the parties' interest in that context.
>
> The defendants' main application concerned the rights and priorities between the [B of M] and [ORRs] at the point after the Receiver had been appointed, but before the bankruptcy....
>
> The subordination clauses within the debenture and loan agreements, by their terms, contemplated a subordination of the [B of M's] interest under the debenture to the previously granted interests of the [ORRs]. Explicitly, they allowed those [ORRs] to rank ahead of the debenture holder in regards to their interests.... The commercial reality in the oil and gas industry, in conjunction with the financial industry, required that documents of that nature be given that effect.

8 The December 1995 Decision has been appealed to the Court of Appeal and is expected to be heard in the fall of 1997. Notwithstanding the Court's ruling with respect to the application for summary judgment therein (and a similar ruling I understand was made on a similar application by the B of M before another member of the Court), the parties have now requested (by consent) that the Court determine the priorities between the parties in bankruptcy on a summary basis, relying on the material before the Court. It is further contemplated that, because of the substantial issues to be determined and the dollar effect of those issues, the within Decision will be added by the unsuccessful party(ies) to the matters to be heard before the Court of Appeal in the fall. Accordingly, the application resulting in this Decision comes forward by way of an agreement between the parties, concurred in by the Case Management Justice, Forsyth, J., that the matter be heard by myself.

**V. Issue - Question to be Decided and its Relevance**

9 The precise question to be decided was intentionally not articulated by the Court in the formal Order setting the hearing of the application, so as to permit further arguments on, and refinement of, the question during the hearing of the application. However, in substance the issue it is to ask the same question as in the December 1995 Decision, but at a later time, namely, the priorities between the B of M and the ORRs, after the point of bankruptcy.

10 While not substantially different in substance, the parties describe the question in various ways. Counsel for B of M stated it thus in their legal brief:

> ...the effect or effects, if any, of the bankruptcy of Dynex upon the finding of the Court in its Order of December 20, 1995.

Counsel for Meridian Oil Inc. and Odessa Natural Corporation ("Meridian and Odessa") stated it thus in their legal brief (opening and para. 14 [1]):

> ...the effects, if any, of the intervening bankruptcy of Dynex ... on the subordination of the [B of M's] security interest to Odessa's and Meridian's overriding royalty.

  

> Has the intervening bankruptcy of Dynex ... affected the subordination of the [B of M's] security interests to Odessa's and Meridian's overriding royalty?

Counsel for Enchant Resources Ltd. and D.S. Willness ("Enchant and Willness") was slightly more elaborate (para. 51):

> At the moment in time after the Bankruptcy of [Dynex] and after debentures issued by [Dynex] to [B of M] had crystallized, is the security granted by [Dynex] to [B of M] in those debentures and securities under the *Bank Act* subordinated to or do they rank in priority to, or extinguish, the interests of [Meridian and Odessa, and Enchant and Willness] in the said Overriding Royalty Agreements and Net Profit Agreements?

Finally, Ernst & Young Inc., in its capacity as Trustee in Bankruptcy for the Estate of Dynex, a bankrupt, and, as Court appointed Receiver Manager, pursuant to the B of M security (by Orders of June 25 and August 20, 1993), of Dynex ("Ernst & Young [2] ") stated the question this way:

> What effect, if any, does the bankruptcy of May 26, 1993 of [Dynex] have with respect to the Court's findings, as reflected by its December 20, 1995 Order?

All of these expressions, in my view, create the same question, as identified at the beginning of these Reasons, but, in hindsight, the articulation by Counsel for Meridian and Odessa most precisely defines the point in issue.

11 I intend to build on the facts found in the December 1995 Decision, which, in large part, set out the nature of the interests of the parties, and the nature of the subordination, just prior to bankruptcy. With those interests properly understood as a background, I then propose to look at what the interests of the parties were at the point of bankruptcy (ignoring the subordination for the moment), and finally to analyze the effect of the bankruptcy (if any) on the subordination. This order of determining rights in not an inappropriate way in which to determine matters, as pointed out by *Goode, Principles of Corporate Insolvency Law* (London: Sweet & Maxwell, 1990) ("*Goode* - Principles"), at 17:

> ...corporate insolvency law for the most part recognizes and adopts rights conferred by the general law and by contract.
>
> . . . . .
>
> The general rule is that the commencement of an insolvency proceeding does not of itself terminate contracts or extinguish rights, though it does inhibit the pursuit of remedies. The starting position of insolvency law is that rights accrued prior to the insolvency proceeding will be respected. To this principle there are important exceptions....

12 I said in the December 1995 Decision that the question of the priorities between the parties after receivership and prior to bankruptcy was not moot. Answers to further enquiries in the within application elaborated upon that. As I understand it, without intending to be too technical about the matter, there have been ongoing revenues in the form of the proceeds from the sale of petroleum and natural gas production resulting from the leases, notwithstanding the financial troubles of Dynex. To a certain point in time, the share due to the ORRs flowed to them in regular monthly cash payments. While the bankruptcy was relatively quick on the heels of the receivership, there were some funds generated during the period of (and perhaps even before) the receivership and prior to bankruptcy, for which the ORRs claim an interest, but which are held by the Trustee. Moreover, there are the regular proceeds of the production that have been held by the Trustee subsequent to bankruptcy, which, since the sale of Dynex's assets by the Receiver to Channel Lake Petroleum Ltd. ("Channel Lake"), approved, with reservations, by Court Order dated September 1, 1993 (on which more later in these Reasons), constitute in excess of $1.1 million (Meridian & Odessa legal brief, para. 9). Finally, there are the proceeds of the sale of the assets of Dynex by the Trustee to Channel Lake (including the interest of Dynex in the subject leases), from which have been reserved and held in the hands of the Trustee some $5 million purporting to represent the value of the acquisition of the ORRs interests. This latter matter deserves some further recognition of the facts.

  

13 To be stated relatively simply, as I understand it from the material, after the bankruptcy, the Receiver Manager effected a Court approved sale of the oil and gas properties of Dynex to Channel Lake, reserving out certain issues with respect to whether or not the Receiver Manager had the right to sell the ORRs interest and the effect of the bankruptcy on the revenues from the production. For the purposes of these Reasons that circumstance is set out relatively succinctly, but in more detail, among other places, at paragraph 24 of the legal brief of Counsel for Enchant and Willness, referring back to the legal brief of Counsel for the B of M filed November 9, 1994 in the within action. That statement, appropriately edited, is as follows:

> Shortly after this action was commenced, a receiving order was made against [Dynex] under the *Bankruptcy and Insolvency Act* and Ernst & Young was appointed as Trustee in Bankruptcy. Pursuant to orders of this Court made on June 25, 1993 and August 20, 1993, [Ernst & Young] was also appointed by this Court as a Receiver under the *Judicature Act* of all the petroleum and natural gas properties of Dynex and of all the claimed interests of the [ORRs] therein under the contracts specified in the Order. By order made August 20, 1993, the Receiver was authorised to sell the properties to [Channel Lake]. Channel Lake was ordered to pay and to continue to pay to the Receiver all payments attributable to the [ORRs] pursuant to the Royalty Agreements which were designated as the "Disputed Interests". These payments now aggregate approximately $5,000,000 with respect to all the [ORRs] in this Action and are being held pending determination of the relative priorities of the parties to this action.

14 Therefore I understand that proceeds not only from the sale of the "Disputed Interests", but also the proceeds from production from the properties since bankruptcy, for which the ORRs claim an interest, are being held by the Trustee to the extent of the purported interest of the ORRs.

**VI. Categorization of the Interest of the ORRs**

15 Without retreading on the December 1995 Decision that the interests of the ORRs were not interests in land (on which I will have more to say later), because, on the material before me, they could not, in law, be interests in land, the question then remains as to what were the interests of the ORRs. If the interest of the ORRs were not interests in land (upon which the Court of Appeal will undoubtedly have further to say), it is clear that the interests are, in that context, *choses in action*.

16 While this is not the decision in which to provide a treatise on the meaning of a *chose in action*, a brief understanding may be helpful to consider more clearly the true nature of the interests of the ORRs. A right to benefit under a contract is a *chose in action*: Waters, *Law of Trusts in Canada* (Second Edition) (Toronto: Carswell, 1984), at 141. *Black's Law Dictionary* defines a *chose in action* as "a right to personal things which the owner has not the possession, but merely a right of action for their possession", including "all property in action which depends entirely on contracts express or implied". While there are undoubtedly further and even more detailed definitions of a *chose in action* in law, this case is more easily resolved if one looks first at a *chose in action* in a simple, common, lay form of understanding (as I tried to do throughout my December 1995 Decision and will attempt to do so in these Reasons).

17 In lay language, pertinent to this case, the interests of the ORRs, are rights, to the extent of the percentage of their interests in accordance with the documents creating the same, to receive a portion of the proceeds of the sale of petroleum and natural gas substances from the leases held by Dynex. Keeping with lay terminology, they are not rights to any specific tangible chattel or thing. Moreover, to the extent that the December 1995 Decision is correct, they are not interests in real property. That is, they are not rights to a *piece* of property (personal or real). What are these rights? They are intangible personal property rights - contractual rights - in this case, as I have said, the rights to receive a portion of a revenue stream from production. Using a hypothetical example, they are as if, for consideration, but without providing a capital fund, the ORRs were given rights to a monthly annuity equal to some percentages of production, or shares of profits, etc.

 

18 What is the effect of a bankruptcy of the holder of these contractual rights? Normally, in a bankruptcy, such rights would (absent other facts) constitute simple debts for past (and damages for future) revenues, the rights to which would be changed by the bankruptcy to a right to register an unsecured claim with the trustee in bankruptcy. However, the issue in the case at hand, is whether the documentation under which the ORRs received these interests, the registration (or lack thereof) of the documentation, and the subordination by the B of M of its interest to those interests, give them more? Let us look at the possibilities and consequences, and then determine whether the ORRs interests are merely unsecured claims in debt/damages in bankruptcy, in comparison to the claim of the B of M, or some higher state.

**VII. Classification of the Interest of the ORRs and The Bankruptcy Consequences of the Classification**

19 From the legal briefs and the submissions of Counsel to the Court, it appears that the interests of the ORRs in bankruptcy consists of one of four possibilities. These four possibilities are the following:

(1) trust interests;

(2) secured creditor status as to real property, by virtue of real property interests;

(3) secured creditor status as to personal property, by virtue of personal property interests; and

(4) unsecured creditors.

20 For the purposes of these Reasons, it is recognized that, in comparison, the interest of B of M is that of a secured creditor, with fully registered real and personal property interests, a status effectively recognized by the Court on August 20, 1993, when it was declared that the Bank had a valid and subsisting charge on all of the assets of Dynex, subject to the determination of the issues relating to the interests of the ORRs.

21 Simply put, without considering the considerable issue of subordination (to which I will turn shortly), the bankruptcy consequences of these classifications (using the same numbering) are that the interests of the ORRs in question would have priorities, *vis-à-vis* the B of M, as follows:

(1) preferred and rank in priority to the B of M;

(2) secured creditors, ranking at least equal to the B of M, as to real property interests;

(3) secured creditors, ranking equal to the B of M, as to personal property interests, but ranking after the B of M in respect of any real property interests; and

(4) unsecured creditors, subject in priority to the B of M secured creditor interest.

Each of these possibilities deserve further detailed examination.

***A. Trust Interest***

22 Insofar as the ORRs interests represent a trust interest, it would mean that Dynex held the interests in trust for the ORRs and it is generally conceded (Counsel for Ernst & Young admits) that such interests would be outside of the bankruptcy.

23 This conclusion is consistent with the following "second principle of insolvency identified by *Goode* - Principles, at 18:

**Second Principle: only the assets of the debtor company are available to creditors**

  

> ...It is not the function of corporate insolvency to confiscate for the benefit of creditors assets in the company's possession or control which belong to others. Only that which is the property of the company at the time of liquidation or comes into its hands thereafter is available for its creditors. So assets held by the company on trust do not form part of its estate...

It is also consistent with s. 67 of the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3 ("BIA"), which provides as follows:

> (1) The property of a bankrupt divisible among his creditors shall not comprise
>
> (a) property held by the bankrupt in trust for any other person,

24 The onus is on the party claiming a trust relationship to establish it, by showing, *inter alia*, that it capable of being identified and that there was a clear intention to create a trust: *Bennett on Bankruptcy* (Third Edition) (North York: CCH Canadian, 1993), at 97.

25 Again, in lay language, property that is held in trust for a third party by an entity that/who becomes bankrupt, is, on bankruptcy, delivered to that third party by the trustee in bankruptcy, and no other creditor has a claim on it, because it never was the property of the bankrupt, and the trustee only takes what the bankrupt owned. Again, a hypothetical example, in simple lay language, could be considered. If a third party takes furniture to a furniture repair establishment for repair and, prior to its redelivery to the customer, the repair company goes into bankruptcy without title to the furniture passing to the repair company, that would be, in simplistic terms, a trust relationship where the property would remain owned by the third party and be delivered to the third party by the trustee in bankruptcy. This is to be distinguished from a situation where, if the furniture were sold to the furniture repair company, but the payment proceeds were not delivered to the third party prior to bankruptcy. In such a case, the funds held by the trustee would not be trust funds but would be held subject only to an unsecured claim by the third party who had sold the furniture. At the risk of oversimplifying the matter, that is the difference between them, and applicable to this case.

26 It is clear from the hypothetical example, and in law, that there need not be a specific document or specific types of wording to constitute a trust: *Bank of Nova Scotia v. Société Générale (Canada)*, [1988] 4 W.W.R. 232 (Alta. C.A.) (the "*Sorrel*" case). Indeed, the whole relationship of trust is being continually expanded into resulting trust, constructive trusts and other fiduciary relationships.

27 Counsel for Enchant and Willness argued that a trust existed because the assignment of the interests to the ORRs were absolute, for consideration, and without the need for any conversion or "back in" by the ORRs. Again, however, while no specific words are necessary, the intention that Dynex held the interests in trust for the ORRs as against all the world must both be clear, and they must be interests capable of being so held. Here the interests are not interests in real property, or lease payments from the lease of real property (e.g. as in *Scurry-Rainbow Oil Ltd. v. Galloway Estate* (1993), 138 A.R. 321 (Alta. Q.B.) (Hunt, J.)), or a specific personal asset (e.g. an existing fund, as in the *Sorrel* case), but contractual rights to future revenues after bankruptcy - a *chose in action* [3] . They are property rights, in the sense that they relate to personalty, but they are rights to future revenues, unlike a specific existent fund held in a trust account - e.g. an RRSP, a deposit, etc.. Even if that does not prevent such a trust, there must be an intention to create a trust relationship.

28 In *Sorrel*, the issue related to specifically ear-marked funds paid to the operator of petroleum production facilities, by non-operators, that were in excess of that required for operations. The headnote sets this out in the following way:

> The creation of a trust does not require express words, and ... a trust could be inferred from an examination of the entire agreement. The subject-matter (the excess funds and revenues [on deposit with the operator] and the object (the non-operators) of the trust were certain, and the agreement as a whole evinced an intention to create a fiduciary relationship between the parties.

Consequently, in *Sorrel*, the Court held that excess revenues and interest thereon were trust funds.

 

29 It is also clear from the documentation that the ORRs owned nothing independent of, or except through, the interest of Dynex. This is evident in the documentation in that Dynex (in the case of Odessa and Meridian, as can be seen in the Document Record, Tab 25) was entitled to fail to keep the subject leases in good standing, and to allow them to expire, to abandon them, to release them, or surrender them (not transfer or encumber). Therefore, in effect, Dynes was entitled to abandon any of its interest, without liability to the ORRs - I find such rights to be inconsistent with the intention to create a trust.

30 The Trustee argued that this was not the time or method to determine if there was a trust relationship, but that it should be determined under the expedited procedure of s. 81 of the BIA, the onus of which was on the party seeking to establish the trust under s. 81(3). More substantively he argued that all the documentation was against the interpretation of a trust - if it was trust property, then there was no interest for which to make the B of M subordinate, and, indeed, there would be no need for a subordination..

31 Counsel for the B of M argued (this argument was not challenged) that to create a trust there must be three elements of certainty: intent, subject matter and object. His further argument (not accepted by Counsel for the ORRs) was that there was no certainty of subject matter because the interests were, at best, rights to a revenue stream which, at any future point (after bankruptcy) were not certain. Counsel for Enchant and Willness argued that there was certainty, and that production records and monthly statements confirmed this. Counsel for the B of M further argued that there was no evidence of intent, and noted that the agreements were commercial contracts between sophisticated parties and, while no words of trust was necessary, the agreements not only had not one word to suggest a trust, but did not look like a trust either.

32 On the documentation I have examined, I can find no words that would constitute a trust relationship, any more than a promissory to pay (as in a promissory note) would constitute a trust. It is clearly not every promise to pay that constitutes a trust, and, in my view, the courts should be slow to so find, absent a very clear indication, such an intention. This so because there is a need for certainty as to whether or not a trust exists and that is particularly important so that parties (such as the B of M and the ORRs in this case) dealing with a debtor (Dynex in this case) can be aware of what their rights might be in the context of various scenarios (for example what happened in this case, a bankruptcy), and contract accordingly.

33 In considering this matter, I am very mindful that there is a substantial desire by the ORRs that their interests be classified as trusts because that would effectively determine this issue in their favour and in priority to the B of M. Indeed, there may be good policy basis for declaring such interests to be trusts. However, this Court is not a policy court, but rather must rely upon the facts as known to the Court and the law applicable thereto.

34 In the result, I have concluded that Counsel for the ORRs have not met the onus on them to establish that the interests of the ORRs are trust interests - that is, there is nothing present in the documentation to create trusts, or to show intentions to create trusts, in favour of the ORRs.

***B. Secured Creditor by Virtue of an Interest in Real Property***

35 As noted, it is conceded that, to the extent that the registered security of the B of M gives it an interest in real and personal property, it is a secured creditor for both the real and personal property of Dynex in the bankruptcy. As a result of this conclusion, the issue of the nature of the interests of the ORRs (if less than real or personal property registered security interests) may be academic, unless the ORRs benefit from the subordination of the B of M's interest to theirs in any event of bankruptcy, because it would appear from the submissions before the Court, that any interest that is caught by the secured creditor status of the B of M would more than consume the assets of Dynes, leaving nothing for the Trustee to distribute to the unsecured creditors.

36 In the December 1995 Decision, I have already ruled that the interests of the ORRs, being neither interests in a lease, nor rentals therefrom, but interests ranking below a lease, cannot, at law, be real property interests, and, in the

  

alternative, if that decision were wrong in law, that a trial of an issue would need to be held to determine whether real property interests had in fact been created. Such latter determination might be further complicated in cases where the ORR was the lessee and remains bare leasehold title holder still (*vis-à-vis* the lessor), but had assigned the leasehold interest to Dynex, retaining a royalty or net profit interest only - see, for example para. 3 of the legal brief of Counsel for Enchant and Willness.

37 The December 1995 Decision having been made on this point, I am *functus* on the issue and the result, pending appeal, can only be that the ORRs have no real property interests, or, alternatively, if they potentially can, that has not been determined. Therefore, I have effectively determined that the ORRs are not secured creditors by virtue of any real property interests. That being the case, the ORRs would have no priority over the B of M, but, indeed, in bankruptcy, and without considering the effect of the B of M's subordination agreement, would be unsecured creditors, subordinate to the B of M.

38 While the legal brief of Counsel for Enchant and Willness takes great pains to point of their registration of caveats at the relevant land titles office ("LTO"), there is no real issue of registration of the ORRs interests at the LTO because the B of M was not only aware of their interests (see paras. 35 and 47 of the legal brief), but specifically recognized them, and subordinated its interest to the ORRs. It is equally clear, as Counsel for Enchant and Willness pointed out (paras. 29 and 38 of his legal brief, and para. 2 of his reply legal brief), that the B of M did not purport to register any claim to the interests of the ORRs or to seek any security interest in the ORRs interests - indeed, the subordination specifically excluded these interests from the B of M security.

***C. Secured Interest in Personal Property***

39 Again, consideration of this may well be academic, aside for the issue of subordination, because, it was fairly conceded that to the extent that the B of M did not consume all of the assets of Dynex as a secured creditor, based on it real property security, it had personal property security duly registered to capture any remainder, leaving nothing for unsecured creditors. Thus all that would be left by the ORRs attaining this status would be for the ORRs to rank equally (subject to the subordination issue) with the B of M for any remaining personal assets of Dynex.

40 Counsel for the ORRs argue that the documentation under which the ORRs obtained their interests contain certain "charging language" which creates a personal property security interest. This argument does not appear to be made to support a secured position in bankruptcy, because it was acknowledged that the ORRs did not register any such interest and therefore had no priority over the Trustee under s. 20 of the *Personal Property Security Act*, S.A. 1988, c. P-4.05 ("PPSA"). However, the argument was apparently made to answer the argument of Counsel for the B of M that s. 40, which resolved the lack of privity issue, only applied to security interests (see para. 12 of Counsel for Meridian and Odessa's legal brief). I have already deal with that in the December 1995 Decision by holding that it applies to "any interest". Nevertheless, I will address the arguments based on "charging language".

41 Such charging language is seen in the documentation conveying the overriding royalty interest in paragraph 2.(c) of the Odessa Overriding Royalty Agreement dated August 29, 1975 (later assigned to Meridian) (see Document Record, Tab 24):

> The said royalty shall be deemed hereafter to be a charge and encumbrance against the [Dynex] interest and accordingly any ... alienation of the [Dynex] interest shall be subject to the said royalty.

There was no such "charging language" appearing in the brief overriding royalty agreement of February 27, 1974, by which Mr. Willness received his interest, or the Enchant overriding royalty agreements of January 22 and 24 (3 in number), 1975. However, as set out in detail in the December 1995 Decision (and, in particular, paras. 53 - 70), the various debentures and loan agreements between Dynex and B of M refer to the lands being free of any "lien", "charge", "encumbrances", or "permitted encumbrances" (or wording of like effect), except for the ORRs interests, and were specifically "subject to" those ORRs interests. Nevertheless, I believe that the ORRs would be hard pressed to have such language interpreted as "charging language" so as to found "security interests" in a legal sense, whether personal or real, based on such language.

42 However, whether there are "charging" provisions to create a security interest, or not, is not necessary to decide because I agree with Counsel for Meridian and Odessa (para. 11) that their interests in the overriding royalties entitling them to a stream of revenues are sufficient, without "charging language", to constitute security interests to personal property in themselves.

43 We see from s. 1(1)(qq) of the PPSA that a "security interest" includes "an intangible that secures payment or performance of an obligation", which would include a *chose in action*, unless otherwise excluded by another definition or provision of the PPSA. Section 4 provides that:

> Except as otherwise provided under this Act, this Act does not apply to the following:
>
>> (g) the creation or transfer of an interest in a right to payment that arises in connection with an interest in land, including an interest in rental payments payable under a lease of land, but not including a right of payment evidenced by a security or an instrument;

A "security" and an "instrument" under s. 1(1)(oo) and(u) respectively would appear, in general lay language, to include such things as a share or other investment certificate, or a bill of exchange, or, in general, some form of negotiable instrument. Thus, we see that, as *choses in action*, the interests of the ORRs are registerable under the PPSA, by virtue of s. 1(1)(qq), unless excluded under s. 4.

44 Counsel for Enchant and Willness argued that the interests that the ORRs received were created and arising, if not in, "in connection with", an interest in land, as contemplated by s. 4. He argued that the ORRs interests were created at the time of the creation of the leases, as *profits à prendre*. I have rejected that status in my December 1995 Decision. Of course, it follows that if Counsel is correct, and I am wrong, and if the PPSA does not apply, s. 20(1)(b) has no effect and does not create any rights in favour of the Trustee. As this would appear to depend on my reasoning in the December 1995 Decision, and I am *functus*, I leave the matter for the further consideration of the Court of Appeal. Nevertheless, s. 40 referenced in my December 1995 Decision, would still apply, because it gets its application, not from the interests of the ORRs, but from the registration by the B of M of its security interests, in which the subordination is included. Put another way, even if the ORRs interests did not qualify as security interests under s. 1(1)(qq), such a determination is not necessary for s. 40, because it can be "any other interest". Thus, in Alberta, the ORRs can rely upon s. 40 to avoid the privity issue, fatal at common law (*Chiips*, at para. 76), whether or not their interests were security interest or registered under the PPSA - different from the Ontario PPSA, as I held in the December 1995 Decision, and Counsel for Meridian and Odessa correctly restates in paras. 1(a), and 7 - 10 of their legal reply brief.

45 However, as I interpret s. 4(g), in conjunction with my December 1995 Decision that the ORRs interests are not interests in land, it is only rental payments to lessors, or the equivalent, that "arise in connection with an interest in land", that are excluded. The exclusion would not relate to overriding royalty or net profit interests of the type held by the ORRs, unless the ORRs could establish that they were akin to lessor rental "payment that arises in connection with an interests in land". Leases are interests in land, and accordingly lease payments to lessors pertinent thereto "arise in connection with an interest in land". However, in my view, as the ORRs interests are not payments to lessors arising from the leases, but interests created "downstream" of the lease, they are not interests in land, and the payments thereunder do not "arise in connection with an interest in land". The result is that the ORRs interests are registerable under the PPSA, and registration is not excluded by s. 4.

46 However, while registerable, none of the interests of the ORRs were in fact registered under the PPSA. Accordingly, no registered personal property security interest sufficient to create a secured creditor status (as to personal property) has been established by the ORRs.

  

47 Further, as the ORRs interests were never registered under the PPSA, s. 20(1)(b)(i) thereof makes it clear that any security interest is not effective as against a trustee in bankruptcy:

> A security interest
>
> . . . . .
>
> (b) in collateral is not effective against
>
> (i) a trustee in bankruptcy if the security interest is unperfected at the date of bankruptcy, ...

The effect of this, as Counsel for the B of M argued, and Counsel for the ORRs concede (Counsel for Meridian and Odessa, para. 13), was that, as of the bankruptcy, at best, the ORRs had a unperfected security interest, and because it was unperfected it was ineffective against the Trustee (see *Bellini Manufacturing & Importing Ltd., Re* (1981), 32 O.R. (2d) 684 (Ont. C.A.), at 691). Accordingly, all property interests in Dynex that were not subject of a real or personal property interest duly secured and registered (which would, subject to the subordination, not include the interests of the ORRs), passed to the Trustee: s. 71 of the BIA.

48 However, this may not end the matter, because Counsel for Meridian and Odessa argued that failure of the ORRs to register their personal property interests under the PPSA did not extinguish the ORRs rights in subordination at common law (authority for this is argued to be seen in *Euroclean Canada Inc. v. Forest Glade Investments Ltd.* (1985), 16 D.L.R. (4th) 289, 4 P.P.S.A.C. 271 (Ont. C.A.)), or under the BIA. I shall address this issue below.

49 Counsel for Enchant and Willness argues that it would be ridiculous to believe that the ORRs would have to register under the PPSA to protect their interest in certain situations, and, in effect, that this was not the intention of the law. The response is that even if this was not what the PPSA had set out to do in the context of these (or other) oil and gas interests, that would appear to be the effect of the law (as discussed above), and those who did/do not take the steps to register might not be protected in certain situations - bankruptcy being the one in this case.

50 The result of the application of the PPSA to the ORRs is that s. 20 is applicable to make any unregistered security interests of the ORRs ineffective against the Trustee, thereby denying secured creditor status as to personal property.

***D. The Unsecured Creditor***

51 As I indicated above, the interests of the ORRs, based upon the limitations from my December 1995 Decision relative to real property, are that of *choses in action*, which entitles them to their appropriate proceeds from the sale of petroleum and natural gas substances - in essence a revenue stream based thereon.

52 The result, I find, in the context of bankruptcy, is merely the entitlement to a debt for a past, or damages for an ongoing, monetary sum against Dynex which would render the ORRs unsecured creditors.

53 On this basis, leaving aside the issue of the subordination, it is clear that the ORRs rank much behind the B of M as to priorities in bankruptcy. The interests of the ORRs prior to bankruptcy had priority over the claim of the B of M because they were specifically permitted to be encumbrances ("permitted encumbrances") in the subordination by the B of M to the ORRs, as I found in the December 1995 Decision. If this subordination survives the bankruptcy (which I will examine below), this may not be fatal to the ORRs. However, if the subordination does not survive the bankruptcy, the priority that existed to the ORRs prior to bankruptcy would be lost. Theoretically, that such priority would be lost in a bankruptcy should not be surprising, as with so many other circumstances, bankruptcy changes the rights of parties and the relationship between parties. Again, by way of analogy, and in support of this basic conclusion, Counsel for the B of M effectively pointed to the example of the status of employees who, in a general sense (without being too legalistic), would have priority for their salaries prior to bankruptcy, but in a bankruptcy would be limited to a certain fixed amounts and thereafter would rank as unsecured creditors.

 

**VIII. The Effect of Bankruptcy on the B of M's Subordination to the ORRs**

54 I have determined that, in the bankruptcy of Dynex, the true interests of the ORRs are those of unsecured creditors and the interest of the B of M is that of a secured creditor (over both real and personal property) of Dynex and in priority to the ORRs.

55 In face of this the lay person then would ask: "Well, what is the effect of the B of M's specific agreement to subordinate its interest to that of the ORRs?" In short, is the effect of that subordination lost by the act of bankruptcy?

56 Before commencing this subject, it should be noted that it appears from the authorities that Counsel have provided, and some brief Canada wide case research that I have done myself, that there are very few useful (especially case) authorities on the subject of subordination. This caused Goode, in a text released prior to his *Principles of Corporate Insolvency Law*, to observe at one point, in *Legal Problems of Credit and Security* (London: Sweet & Maxwell, 1988) ("*Goode* - Problems"), at 24:

> Again, I cannot quote chapter and verse. So far as out textbooks are concerned, nobody ever enters into subordination agreements, because they are nowhere mentioned!

Although Philip Wood appears to have answered this call in his later text, *The Law of Subordinated Debt* (London: Sweet & Maxwell, 1990) ("*Philip Wood*"), this remains an area of extremely limited authority. With this severe limitation, I start the discussion to attempt to determine this issue.

57 As noted above, It is clear that enforcement of a subordination agreement does not require that the beneficiary of the subordination register his interest: *inter alia*, *Chiips Inc. v. Skyview Hotels Ltd.* (1994), 21 Alta. L.R. (3d) 225 (Alta. C.A.), at 237 (para. 34), referencing *Euroclean*; and Cuming & Wood, *Alberta Personal Property Security Act Handbook* (Third Edition) (Carswell) ("*Cuming & Wood*"), at 337.

58 While not decisive of the matters before me, it would appear that the subordination has no direct effect on the Trustee, or the results in the bankruptcy itself. This is so because, as I understand it, the Trustee does not normally recognize interests, except insofar as they, having created some form of security status in bankruptcy, must be examined further to determine priorities. If two claimants had the same security position in bankruptcy, then the Trustee would have to give effect to interparty subordinations to determine the priorities of the similar claimants. Thus, if the ORRs had registered their security interests in their *choses in action* under the PPSA, such that there was a competition between the ORRs and the B of M for Dynex's personal property interests, those interests would be binding on the Trustee, and the subordination might need to be considered to determine the priority between them. However, that is not applicable in this case by virtue of the failure of the ORRs to register their security interests, and accordingly they gained no security position that the Trustee had to recognize, by virtue of s. 20 of the PPSA. Thus, the Trustee had no need to have regard to any subordination arguments because the ORRs failure to register under the PPSA had the effect in the bankruptcy that the ORRs are unsecured, and therefore rank considerably behind the B of M. Therefore, the subordination in this case has no direct relevance to the bankruptcy itself, or to the Trustee.

59 That the benefit of the subordination to the ORRs was lost in bankruptcy was the nature of the argument of Counsel for the B of M, when in their legal brief they stated (paras. 27, 30, 31 and 32):

> 27. *If the ... interest of* the beneficiary of the subordination [*the ORRs*] should be satisfied, *discharged*, invalid or *otherwise unenforceable* against the debtor's [Dynex] property, *the subordination ceases to have any effect. There is no interest which can have the benefit*.

. . . . .

 

> 30. The bankruptcy of Dynex vested all of its property in its trustee in bankruptcy subject only to the rights of secured creditors as holders of security that would be enforceable against such property and the trustee in bankruptcy. The only holder of such security is the [B of M].
>
> 31. The charges, encumbrances or interests of [the ORRs] ... are not effective against the trustee in bankruptcy since they ... were never perfected in accordance withe the PPSA.
>
> 32. *As a result of the bankruptcy* of Dynex, *the* [*interests*] *of* [*the ORRs*] in ... Dynex *ceased to exist*. The only remaining rights of [the ORRs] ... are to claim as unsecured creditors....
>
> 33. ... *Upon bankruptcy* ... [*t*]*here is no longer any interest that can receive the benefit of a subordination...* [Emphasis added.]

By this I understand the position of Counsel for the B of M to be that, on bankruptcy, as the *chose in action* rights of the ORRs give way to merely unsecured creditor claims, because the ORRs have no registered security interests to pursue those rights directly (as they would if they were secured creditors, by virtue of registration under the PPSA), any such previous rights held at the time of the subordination are "lost" and there is nothing left to be the subject of the subordination, and, thus, the effect of the subordination is equally lost.

60 Counsel for the ORRs argue, however, in effect, that: "[b]oth before and after the bankruptcy of Dynex, the [B of M's] security is subordinated to the interests of [the ORRs]" (para. 15); the subrogation by the B of M was not in favour of any specific security interests held by the ORRs, but of all (and any) of the interests of the ORRs, whatever those interests were, including any rights as unsecured creditors; the loss of the *chose in action* interests of the ORRs by virtue of the bankruptcy did not leave the ORRs without any interests, but merely converted them into other interests, namely the interests of unsecured creditors; while collection from the Trustee might, in the circumstances, be impossible, the subordination by the B of M to the ORRs (of what ever interest they had remaining - their unsecured creditors interests) is not lost in the bankruptcy; and, by way of mechanics, the B of M, in realizing on its secured interest, holds that realization in trust for the ORRs to the extent of their interest as unsecured creditors, by virtue of the continuing subordination.

61 There is however a flaw in the arguments of Counsel for Odessa and Meridian (paras. 19 - 22), as I understand them and the authorities relied upon, in support of the proposition that the bankruptcy does not affect the priorities or the subordination. The flaw is that Counsel, relying upon (at para. 19), *inter alia, Goode* - Principle (at 18) "Third Principle: security interests and other real rights created prior to the insolvency proceedings are unaffected by the winding up", presumes that the ORRs are "secured parties" and have real property or personal property security interests, or rights similar in legal effect and status to the B of M - a position that I find does not exist. A subordination agreement does not, by virtue of the subordination alone, and in the absence of specific language to that effect, create a security interest in favour of the beneficiary of the subordination: *Cuming* & *Wood*, at 336. However, that position is unnecessary for Counsel for the ORRs to take, because the subordination of the B of M to the ORRs may exist without the ORRs having any security status.

62 The argument of the ORRs is based on the assertion (paras. 20 and 23 respectively and 15 of the reply legal brief) that "contractual subordinations ... remain enforceable between the parties despite the bankruptcy of the debtor" and "Odessa and Meridian have priority over the Bank by virtue of the Bank's subordination". The authority cited (at para. 20) is *Philip Wood* (at 120) that:

> Contractual subordinations of debt remain enforceable between the parties despite the bankruptcy of the debtor....

Also at 23, *Philip Wood* makes this similar observation:

  

> The better view is that an arrangement between junior creditor and the debtor that the junior creditor is to be contractually subordinated should not in principle conflict with English insolvency rules that liabilities of the insolvent are to be paid *par passu*, but the matter is undecided in England.

No other authority is cited in direct support of this proposition, nor is there any authority cited directly against it by Counsel for the B of M.

63 The argument of Counsel for the B of M in my view can only succeed if the subordination by the B of M in favour of the ORRs was, by its terms, or in law, terminated by the bankruptcy.

64 Looking at it another way, is be impossible for the ORRs to succeed to have priority over the B of M after a bankruptcy, where the B of M is a secured creditor, and the ORRs are merely unsecured creditors? In my view, it would not be, but there would be a couple of requirements. In the absence of finding a trust in favour of the ORRs, what would be required would be a finding that the subordination by the B of M was so broad in its terms, in the absence of any specific statutory or case law to the contrary, as to survive a bankruptcy, and be indifferent to the different security status that the ORRs had in the bankruptcy. That such a subordination is available appears to be recognized by both *Cuming and Wood*, and *Wood* himself, as seen in the former at 302 where they state:

> The subordination agreement may subordinate the debt of the junior creditor to all debt owed by the debtor to the senior creditor. The subordination may postpone the junior debt from the outset, or may provide that the postponement is effective only upon the occurrence of a specified event. The subordination agreement may also limit the subordination to certain kinds of debt (such as debt arising out of a specific credit agreement, debt incurred prior to a specified date, debt up to a specified amount or debt associated with a specific issue of debt securities).

Reference is also made to *Wood*, at 6 - 8.

65 Accordingly, it appears that express agreements between creditors could subordinate priorities in bankruptcy in a way that survives the bankruptcy (and the court should give effect to it), even if the interests are not the same: *Ogden Enterprises Ltd., Re* (1978), 22 N.B.R. (2d) 344 (N.B. Q.B.), at 358; and *Cuming* & *Wood*, at 302 (section 40[1]). The subordination by the B of M in favour of the ORRs is not expressly in relation to bankruptcy. However, is it expressly, or by law, terminated by bankruptcy?

66 From these latter mentioned authorities, we see that a subordination by agreement or law may be "effective only upon the occurrence of a specified event". Accordingly, it would seem to follow that it could be equally "ineffective upon the occurrence of a specified event". The question is whether it is, by agreement or law, ineffective on bankruptcy? If it were not ineffective, with such a broad subordination in place, a subrogation of the type envisioned by Counsel for Odessa & Meridian (relying on *Goode* - Problems, at 98, which in turn relies on *Woodroffes (Musical Instruments) Ltd., Re*, [1985] 2 All E.R. 908 (Eng. Ch. Div.), at 912) would appear to give the ORRs the right to recover through the B of M.

67 Counsel for the B of M argued that the subordination of B of M to the ORRs was a subordination of security not a subordination of debt, and, as a result, the remaining debt of the ORRs in Dynex did not enjoy a priority position to the debt of B of M. I reject this conclusion as unsupported in law or in fact. Let us examine both.

68 In support of the B of M's argument, it is clear that the subordination must be clear and unequivocal: *Sun Life Assurance Co. of Canada v. Royal Bank* (1995), 37 C.B.R. (3d) 89 (Ont. Gen. Div. [Commercial List]), at 94 (para. 23). Nevertheless, "a subordination clause is given effect according to its terms" and "commercial reality requires that documents of this nature be given effect": *Chiips*, at, *inter alia*, 243 (para. 57). While there was great debate in Chiips (referring back to *Euroclean*; *Sperry Inc. v. Canadian Imperial Bank of Commerce* (1985), 50 O.R. (2d) 267 (Ont. C.A.); *Canadian Imperial Bank of Commerce v. International Harvester Credit Corp. of Canada* (1986), 6 P.P.S.A.C. 273 (Ont. C.A.); and *Transamerica Commercial Finance Corp., Canada v. Imperial T.V. & Stereo Centre Ltd. (Receiver of)* (1993), 13 Alta. L.R. (3d) 99, 6 P.P.S.A.C. (2d) 99 (Alta. Q.B.) (Nash, J.)) as to the adequacy of the wording of any purported

  

subordination clause, it being conceded that a vague and non-specific clause is not sufficient (see *Chiips*, at para 49), I believe that no specific "magic" words, such as "rank" or "priority" [4], or any other words are necessary (although they may be helpful) to convey subordination, any more than the word "trust" is necessary to create a trust. *Chiips* seems to confirm this when (relying upon authorities I will not repeat) Foisy, J.A. said (para. 30):

> It is interesting to note that it is possible under the [PPSA] to prove a subordination in fact without the existence of a specific subordination agreement....

69 Bearing these cases and principles in mind, I find, as I believe I already made apparent in the December 1995 Decision (especially paras. 97, 105, and 110), with detailed references to the clauses themselves (especially at paras. 53 - 70), not lack of clear and unambiguous wording to support a very broad subordination in this case - the B of M, to use the language of Harradence, J. A. in *Chiips* (para. 53), was "clearly acknowledging that these [ORRs interests] rank ahead in priority". Further, I find that the subordination by the B of M, on the face of the documents, and at law, was an "unhyphenated" subordination - it was the subordination of the *interest* of the B of M (what ever it was) to the *interests* of the ORRs (what ever they were). It was not a subordination by the B of M over only "part of the property of the debtor held by a junior creditor", nor does the subordination relate only to the B of M's security interest in "personal property of the debtor ... in favour of the interests in such personal property [of the ORRs]", as argued in paras. 21 and 23 of the legal brief of Counsel for the B of M (and other similar declarations in other paragraphs - e.g. 28, and in the Trustee's legal brief at para. 20). Furthermore, there is nothing to say, as Counsel for the B of M would appear to argue (in paragraphs 25 and 26 of the B of M's legal brief), that the subordination was limited to assets over which the beneficiary of the subordination (the ORRs) had a "charge over", or "security interests" registered, or registerable, under the PPSA, or "any other interest". It was a subordination, pure and simple, of what ever are the B of M's interests to the interests (what ever they were or may now be as a result of the bankruptcy) of the ORRs.

70 To this extent, I agree entirely with the arguments of Counsel for Odessa and Meridian at paras. 1(a), 4 - 10, and 18 of their reply legal brief.

71 Additionally, this is not a case, in my view, where there was subordination only of a floating charge security and not a fixed charge security as in the *Chiips* case (para 23), but rather it was a subordination of all of the interest of the B of M.

72 I agree with the essence (if not the precise words) of the reply legal brief of Counsel for Odessa and Meridian (paras. 19 - 22) that the bankruptcy did not extinguish the *choses in action* of the ORRs - indeed, it is those interests that made them creditors (albeit as unsecured) of Dynex in bankruptcy. While it is clear that the nature of the enforcement of the ORRs interests changed from *choses in action* subject of suit, to unsecured creditor claims that would appear to be worthless in themselves, that does not mean that all rights of the ORRs vanished on bankruptcy. To that extent I also agree that "[t]here remains an interest that can receive the benefit of the Bank's subordination". However, to recognize this, I would restate what Counsel for Meridian and Odessa said in the third sentence of para. 21 of their legal brief to indicate that the ORRs in bankruptcy, because their interests were not secured, lose the right to continue to receive revenues under their overriding royalties (the *choses in action*), and, instead, are each left merely with an unsecured creditor's claim based on those *choses in action*. They nevertheless, in my view, continue to be entitled to the benefit of the subordination.

73 In this case I find that the subordination, on its terms, is: for all of the interest of the ORRs in priority of all of the interest of the B of M; it is in effect from the outset, that is, prior to any advances by the B of M; and is not limited by any particular kind of interest. The question then is whether it is expressly or implied broad enough to continue through a bankruptcy? I find that the subordination is broad and that it does not, expressly, or by implication, contemplate a bankruptcy terminating its existence. It does not exclude a bankruptcy, and, with *contra proferentum* running against the B of M (see my December 1995 Decision at paras. 57 and 106), inclusion should be implied. I find that subordination continues, after bankruptcy, in favour of the ORRs against the B of M.

**IX. The Inter-Relationship of S. 40 of the PPSA and S. 59 of the LPA**

  

74 While, in reality the following argument is in reference back to my December 1995 Decision (para. 75), it deals with an aspect that was not there argued in detail, or, alternatively the significance of it was not fully understood by the Court (para. 76). However, it was raised again in this hearing, with a significance that is clearer to the Court. Accordingly, to the extent that I did not there expressly decide the issue, I will respond to the new aspects of this argument, which may be of benefit to the parties, if only for consideration of the Court of Appeal.

75 The issue is privity of contract. In this case the ORRs were not privy to the subordination clauses in the agreements between the B of M and Dynex, and, accordingly, at common law, could not enforce them: *Euroclean*. However, this is remedied for personal property by s. 40 of the PPSA, which, simply put, reads:

> A secured party may -- subordinate his security interest ... and the subordination ... may be enforced by a third party if the third party is the person ... for whose benefit the subordination was intended..

Nevertheless, the argument was made by Counsel for the B of M that s. 40 only provides privity to the subordination of the B of M's personal property interests and not its real property interests. The answer, Counsel for Meridian and Odessa argued (most specifically at para. 23 of the reply legal brief) is that s. 59.2(3) of the *Law of Property Act*, R.S.A. 1980, c. L-8 ("LPA") makes the lack of privity "solution" in s. 40 applicable to the real property interests. However, Counsel for the B of M advanced the new argument, in oral argument in these proceedings, that s. 59.2(3) was only mechanical to allow personal property registration under the LPA, and not substantive. It has significance because if Counsel for the B of M is correct, the B of M would not be affected by subordination of any of its real property security, due to the lack of privity, leaving only the personal property assets of Dynex available for subordination (see Counsel for the B of M's argument at para. 34).

76 I agree with the argument of Counsel for Meridian and Odessa as a matter of interpretation of the wording of s. 59.2(3). It reads clear, as it relates to s. 40:

> Section ... 40 ... of the [PPSA] ... appl[ies] with necessary modifications to registrations under this section.

It can only mean that the same considerations that apply to personal property interests registered under the PPSA (a cure of the privity issue) also apply to real property interests registered under the LPA. In my view this conclusion is unaffected by whatever is the effect on the LPA of the other PPSA sections referenced in s. 59.2(3) - whether "mechanical", procedural or substantive.

**X. Effect of the Sale by the Trustee to Channel Lake**

77 I do not find that the sale of the Dynex assets by the Receiver makes any question moot (as Counsel for the B of M asserts at para. 34) until the determination of these questions, and the Orders of Forsyth, J. of August 20, 1993 (especially para. 5) and September 1, 1993 (especially paras. 2, 5 and 8), were broad enough to make that perfectly clear both as to the validity and priority of the B of M's security and the sale respectively. Accordingly, I agree with the argument in para. 22 of Counsel for Odessa and Meridian's reply legal brief.

78 As to the ability of the Receiver to sell the leases from which the ORRs obtained their flow of revenues from production, the first reaction (beyond the fact that such sale was specifically authorized by the Court) is that the Receiver could only sell what Dynex had (Per Lord Herschell, L.C. in *McEntire v. Crossley Brothers Ltd.*, [1895] A.C. 457 (U.K. H.L.), at p. 461, referenced at 690 - 1 of *Bellini*), which did not include, or was subject to, the interest of the ORRs. However, the fact is that the Receiver, on behalf of the B of M, received from the Trustee, all of the assets to which the B of M had security that the Trustee received on the bankruptcy. Thus the rights of the Receiver, through the B of M's security, were as great as what the Trustee could have sold, from the assets acquired on bankruptcy, had there been no secured creditors. As the sale of the leases would be a real property interest and the ORRs had no real property interests, the Trustee, or Receiver thereunder, would have an unfettered right to sell the real property. Counsel for the B of M described it thus in their legal brief (para. 35):

  

> Since the [ORRs] rights ... do not constitute interests in land, there is no encumbrance upon the real property of Dynex other than the real property charges ... held by the [B of M]. Since the interests of [the ORRs] are not interests in real property,the sale by the [Trustee] was free of such claims...

79 Insofar as the sale was of personal property interests, including the interests held by the ORRs prior to bankruptcy, the result is the same by a different route. *Bellini*, accompanied by s. 20 of the PPSA, is authority (at 691) that failure to perfect a security interest under the PPSA means that the creditor cannot rely on the doctrine of *McEntire*, even though failure to prefect such an interest does not in itself destroy the effect of the subordination by another creditor: *Euroclean*. In that regard, because the ORRs failed to register under the PPSA, the Trustee acquired, on bankruptcy, more than Dynex had before, because the ORRs unregistered security interests on bankruptcy were converted from specific *choses in action* into mere unsecured claims. It follows that, if the ORRs only interests in bankruptcy were as unsecured creditors, the Trustee is free to sell the assets of Dynex unencumbered by such an interest, and through the B of M security, so is the Receiver.

80 It would therefore follow that the aforementioned determinations also have the effect of determining this additional issue, which was specifically reserved by the Order of Forsyth, J. of September 1, 1993. The effect of this determination is that Channel Lake acquired its interest in the Dynex properties (by the agreement of August 4, 1993), as to real property unaffected by the ORRs as they had no real property interest, and free of the ORRs' overriding and net profits interests in personalty because they failed to register under the PPSA. As such, the $5 million sale proceeds (apparently purporting to represent the value of those chose in action rights) should be released by the Trustee to be distributed in the bankruptcy, and any proceeds of production paid to the Trustee under the terms of the Order for the production since the sale (that pertained to what would otherwise be the entitlement of the ORRs) must be accounted by the Trustee back to Channel Lake effective the date of sale, because they owned those rights as of sale and would no longer be required to account for the revenues therefrom.

81 It follows from the ORRs position as unsecured creditors that, as against the Trustee, any revenues generated from production after bankruptcy to the point of sale, to which the ORRs were otherwise entitled, and the proceeds of sale of the ORRs interests (to neither of which the B of M had any interest), go to the Trustee for distribution in the bankruptcy, unaffected by any claim by the ORRs, except as unsecured creditors. To the extent that those proceeds flow to the ORRs as unsecured creditors, that lessens their loss, and the liability of the B of M to them. However, on the facts before me, in the bankruptcy, I presume those revenues will flow, in the bankruptcy, to the B of M as a secured creditor under registered secured real and personal property documentation, *vis-à-vis* the Trustee.

82 However, that does not end the matter.

83 The revenues from production held by the Trustee for the period of production between the receivership crystallisation and the bankruptcy, are for distribution, without issue as I understand it, to the ORRs (subject to appeal of my December 1995 Decision and this Decision), based on the acknowledgement of Counsel for the Trustee (para. 14 of the Trustee's legal brief) that the proceeds in the hands of the Trustee, as Receiver, relating to the period prior to bankruptcy are held in trust for the ORRs to the extent of their interest. They are unaffected by this Decision and accordingly should, subject to appeal, be so disbursed. However, to the extent that the revenues held by the Trustee for the period between the receivership and the bankruptcy are unable in law to be transferred to the ORRs to the extent of their interests, and flow to the B of M as secured creditor, the B of M must also account for those to the ORRs as hereinafter set forth.

84 It follows that as between the B of M and the ORRs, the B of M, because of its subordination will have to account (see below) to the ORRs for any funds it received directly, or through the Trustee, from the sale of the ORRs interests, and the revenues from production relating to those interests after the bankruptcy until the point of sale. Allow me to elaborate.

  

85 The additional proceeds paid by Channel Lake ($5 million) pending this determination, I assume, without deciding, represent the fair value of the ORRs *chose in action* interests. The B of M has no *direct* claim on those funds as its security interests specifically excluded rights to those interests. However, to the extent that those proceeds, as between the Trustee and the creditors in bankruptcy, should be paid by the Trustee to the B of M, or flow directly to the B of M, based on its secured creditor rights to priority in the bankruptcy, as between the B of M and the ORR's, the B of M must account for them to the ORRs. This brings us to the mechanics of how the ORRs can follow these funds.

**XI. Mechanics of Recovery by the ORRs from the B of M**

86 The mechanics of collection what is due to the ORRs by the effect of the continued subordination, after the bankruptcy, without doing damage to the priorities within the bankruptcy (see *Kenmore Building Materials Ltd., Re* (1966), 9 C.B.R. (N.S.) 41 (Ont. C.A.), at 48; and *Philip Wood*, at 23 (*supra*)) was presented, with authority, by Counsel for Meridian and Odessa, at paras. 23 and 24 (see, similarly, para. 15 of Counsel for Meridian and Odessa's reply legal brief):

> An apparent circularity problem does arise, in that the trustee in bankruptcy has priority over the unregistered interests of Odessa and Meridian; Odessa and Meridian have priority over the [B of M] by virtue of the [B of M's] subordination; and the [B of M] has priority over the trustee in bankruptcy by virtue of it security. However, the solution to the apparent circularity has long been recognized in similar situations occurring in bankruptcy proceedings.
>
>> R.M. Goode, *Legal Problems of Credit and Security*, at 98 (substituting the parties in this action [which I have "collected", and added my own "substitutions"] for Professor Goode's generic parties):
>>
>>> At all events, the problem is readily soluble through the principle of subrogation. Since [the ORRs] ha[ve] priority over [the B of M] by virtue of their agreement [between the B of M and Dynex, but to which the ORRs have rights by virtue of s. 40 of the PPSA], so that [the B of M] would to accountable to [the ORRs] for moneys received in the liquidation to the extent of [the B of M's] subordination, all the interests are satisfied by treating [the ORRs] as subrogated to [the B of M] to the extent necessary to give effect to the subordination agreement. That is to say, [the ORRs] will collect from the liquidator *in right of* [*the B of M*] the amount due to [the B of M], or such part of that amount as is necessary to satisfy [the ORRs claim].... That this is the correct solution was conceded in...
>>
>> *Re Woodroffe's...*
>>
>> *Re Bankruptcy of Rico...*
>
> Accordingly, ... the [B of M] is obliged to hold in trust for [the ORRs] the proceeds it realised from the oil and gas properties affected by [the ORRs'] overriding royalty interests to the extent of the value of those overriding royalty interests.

87 In *Rico Enterprises Ltd., Re* (1994), 24 C.B.R. (3d) 309 (B.C. S.C.), at 322 (para. 38), Tysoe, J. said (I have substituted the parties in this case for his generic terms):

> If [the B of M] subordinates its claim to the claim [5] of [the ORRs] without subordination to other claims ranking in priority to the claim of the [ORRs], it is my view that a distribution of the assets of the bankrupt debtor should be made as if there was no subordination, except to the extent that the share of the distribution to which the [B of M] would otherwise be entitled should be paid to the [ORRs]....

88 The concept of the subordinated creditor holding in trust and accounting to the senior creditor was also discussed by *Goode* - Problems, at 23 - 24, where he said:

  

> ...If the subordinated creditor enforces his security he holds what he receives on trust for the senior creditor up to the amount due to the latter or any lower sum fixed by the subordination agreement - but that in other respects each of the two [interest holders] retains exactly the same interest as he held before. No security interest is intended and none is created.

89 After a consideration of these passages and the arguments of both Counsel for the ORRs and the B of M, I accept this solution as the mechanics by which the ORRs are to recover what is due to them by the continuation of the subordination after bankruptcy.

90 In such circumstance the present value of the ORRs would have to be calculated and paid out to the ORRs by the B of M. The effect of this, from a simplistic lay perspective, would be that the subordination by the B of M, no matter what the status of Dynex, would ensure (I use this word in a lay, not legal, sense) that the ORRs did not rank behind the B of M in any case where Dynex, or the Trustee on its behalf, has an inability to pay the ORRs.

**XII. Conclusion**

91 Based upon the above analysis I find that the interests of the ORRs in bankruptcy are those of unsecured creditors, but that the subordination of the B of M to those interests prior to bankruptcy is not lost in bankruptcy, such that the B of M must account to the ORRs for the revenues earned from production until the sale of those interests to Channel Lake, and the value of those interests on the sale to Channel Lake.

92 Accepting the "Order Sought" provisions of Counsel for Meridian and Odessa (para. 25), I conclude and declare that:

> ...the bankruptcy of [Dynex] does not affect the subordination of the [B of M's] security interest to [the ORRs] overriding royalty and that the [B of M] continues to be obliged to hold in trust for [the ORRs] the proceeds it realized from the oil and gas properties to the extent of the value of [the ORRs] overriding royalty interests.

**XIII. Other Arguments and Issues Considered - Position of Willness**

93 Counsel for the Trustee, in the Trustee's legal brief, raised certain arguments against the status of Mr. Willness as a party to the proceedings. This issue was clearly out of the scope of the issues to be decided at the subject hearing, and notice was not given to Mr. Willness's Counsel, nor did he have an opportunity to respond in his legal brief (filed prior to the counsel for the Trustee's legal brief). As such this matter is not properly before the Court, and accordingly was agreed to be adjourned *sine die*.

**XIV. Order and Costs**

94 Counsel may speak to the Court to resolve any slips or lack of clarity (if any) in these Reasons (relatively hastily assembled), and, if necessary, to work out the terms of the formal Order resulting herefrom.

95 Counsel may also speak to costs at an appropriate time before the formal Order is taken out, by agreement or on motion, but, subject to any such further determination by the Court at the request of Counsel, the ORRs are entitled to their costs, in Schedule "C", in any event of any issues remaining in the cause.

*Order accordingly.*

Footnotes

1 References to paragraph numbers in relation to arguments, unless otherwise stated, or the context requires, are to the paragraphs of the party's written legal brief (or reply brief) filed prior to the hearing.

  

2 The fact that the same firm fulfils both the role of Receiver-Manager and Trustee makes it more difficult to keep separate the function being performed - while I will try to keep these separate, the reader should permit some inadvertent and unintentional confusion.

3 I do not believe it to be disputed in this case that funds otherwise earned by the ORRs up to the point of bankruptcy of Dynex will be accounted to them.

4 However, in the case at bar I note that "ranking" and "priority" are specifically referenced in the B of M's debenture as seen at para. 64 of the December 1995 Decision.

5 In the case at bar it is not the "claims" that are subordinated but the "interests".

TAB 2

2004 CarswellOnt 1842
Ontario Superior Court of Justice [Commercial List]

Air Canada, Re

2004 CarswellOnt 1842, [2004] O.J. No. 1909, [2004] O.T.C. 1169, 130 A.C.W.S. (3d) 899, 2 C.B.R. (5th) 4

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

AND IN THE MATTER OF SECTION 191 OF THE CANADA BUSINESS CORPORATIONS ACT, R.S.C. 1985, c. C-44, AS AMENDED

AND IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF AIR CANADA AND THOSE SUBSIDIARIES LISTED ON SCHEDULE "A"

APPLICATION UNDER THE COMPANIES' CREDITORS ARRANGEMENT ACT, R.S.C. 1985, c. C-36, AS AMENDED

Farley J.

Heard: March 17, 2004
Judgment: April 5, 2004 *
Docket: 03-CL-4932

Counsel: Sean F. Dunphy, Ashley John Taylor for Applicants, Air Canada
Monique Jilesen for Monitor, Ernst & Young Inc.
Kevin P. McElcheran for CIBC
Joseph M. Steiner for GTAA
Mark E. Meland for Summitomo Trust & Banking Co. Ltd., Tokyo Leasing Co. Ltd.
Gregory Azeff for GECAS Inc.
Harvey Chaiton for Dr. Ratthey and Rainer Manthey (DM Bondholders)
S.R. Rickett for Bayerische Landesbank
David R. Wingfield, Kim Mullin for Tudor Investment Corp. & other Senior Financial Creditors
A. Kauffman for Ad Hoc Committee of various Financial Creditors

Subject: Insolvency

MOTION by trade creditors for declaration that subordinated debtholders were not entitled to vote or receive any distribution until claims of all unsecured creditors were paid in full and for declaration that entitlement of subordinated debtholders be distrubuted to unsecured creditors pro rata in relation to their proven claims.

***Farley J.*:**

1 Canadian Imperial Bank of Commerce, Greater Toronto Airports Authority, Airbus, Cara Operations Limited and IBM Canada Limited (collectively "Trade Creditors") moved:

(A) for a declaration that the holders of Subordinated Perpetual Debt

(a) 5 $^{3/4}$ % Subordinated Bonds 1986ff (Swiss fr 200,000,000);

  

(b) 6 1/4% Subordinated Bonds 1986ff (Swiss fr 300,000,000);

(c) 6 3/8% Interest-Adjustable Subordinated Bonds 1987ff (DM 200,000,000);

(d) Subordinated Loan Agreement (Yen 20,000,000,000); and

(e) Subordinated Loan Agreement (Yen 40,000,000,000)

(collectively "SP Debt") are not entitled to vote or receive any dividend or other distribution from Air Canada unless and until the claims of all unsecured creditors, including those whose claims are in respect of borrowed money, have been paid in full;

(B) a declaration that any entitlement of holders of [SP Debt] must be distributed not to such holders but to all unsecured creditors *pro rata* in relation to their proven claim; and

(C) such further and other relief as this Honourable Court deems just.

2 Air Canada ("AC") moved for an order authorizing it and its subsidiary Applicants under these CCAA proceedings "to incorporate the terms of the settlement reached between certain holders of [AC's] Senior Debt and certain holders of [AC's SP Debt] in the Applicants' plan of compromise or arrangement, to be filed (the "Plan")". This settlement was described by AC as follows at item 5 of the grounds:

5. Negotiations subsequently took place and an agreement has been executed between certain holders of Senior Debt and certain holders of [SP Debt] pursuant to which:

(a) Holders of [SP Debt] shall not be included in a separate class, but rather shall be included in a general class of unsecured creditors;

(b) Notwithstanding the treatment of holders of [SP Debt] as herein proposed, each creditor holding [SP Debt] shall be entitled to vote the face value of its claim in the same manner as all other unsecured creditors;

(c) The holders of [SP Debt] shall be entitled to a distribution under the Plan which provides to them, in the aggregate, on a *pro rata* basis, twenty-six percent (26%) of the aggregate distribution which would otherwise be made to them if they were not subordinated to Senior Debt;

(d) Seventy-four percent (74%) of the aggregate distribution which would otherwise be made to the holders of [SP Debt] if they were not subordinated to Senior Debt, shall be distributed, on a *pro rata* basis, to the holders of Senior Debt, in addition to all other distributions to which they are entitled as unsecured creditors under the Plan;

(e) For certainty, a party entitled to a distribution in accordance with the foregoing shall be entitled to receive a corresponding portion of all direct or indirect benefits which may accrue to or be enjoyed by unsecured creditors pursuant to any rights offering, over-subscription mechanism or otherwise; and

(f) The mechanism described above shall allow for the distributions set forth above to occur without the necessity of the holders of Senior Debt or Air Canada enforcing the subordination covenants directly against the holders of [SP Debt].

3 Certain investors ("DM Bondholders") who hold or represent the beneficial holders of approximately 26 million DM of the Deutsche Mark Bonds ("DM Bonds") asserted that since there was no winding-up, liquidation or dissolution of AC, then the subordination of the DM Bonds was not triggered. They relied on the fact that s. 8(2) of the terms of the DM Bonds reads as follows:

 

S. 8(2) Upon any winding-up, liquidation or dissolution of the Borrower, whether in bankruptcy, insolvency, receivership or other proceedings including special Act of Parliament or upon an assignment for the benefit of creditors or any other sequestering of the assets and liabilities of the Borrower or otherwise.

There is no reference to "reorganization" in addition to "winding-up, liquidation or dissolution" as is the case of the SF Bonds or the Yen Loan Agreements:

SF Bonds s. 7

Upon any distribution of assets of the Company (other than such as is referred to in Section 8(2) and in respect of which the Principal Paying Agent has not exercised its rights contained in Section 8(22) or upon any dissolution, winding up, liquidation or reorganization of the Company, whether in bankruptcy, insolvency, reorganization, receivership or other proceedings or upon any assignment for the benefit of creditors of any other sequestering of the assets and liabilities of the Company or otherwise,

Yen Loan Agreements para. 6.4.2

Upon any distribution of assets of the Borrower (other than such as is referred to in Clause 10(h) where the surviving company assumes all the obligations of the Borrower) upon any dissolution, winding up, liquidation or reorganization of the Borrower, whether in bankruptcy, insolvency, reorganization or receivership proceedings or upon an assignment for the benefit of creditors or any other sequestering of the assets and liabilities of the Borrower or otherwise in or upon any similar or analogous proceedings or event: -

No explanation was given for the difference in language so we are left in the dark as to whether it was intentional on a negotiated basis or simply inadvertent drafting.

4 Each of the SP Debt instruments contains subordination provisions. While all the provisions are not identical, they are substantially similar. The following are definitions from the November 14, 1989 Yen Loan Agreement:

"Indebtedness" - the principal, premium, if any, and unpaid interest (including interest accrued after the commencement of any reorganization or bankruptcy proceedings) or any indebtedness of the Borrower for borrowed money, whether by way of loan or evidenced by a bond, debenture, note or other evidence of indebtedness and whether secured or unsecured, including indebtedness for borrowed money of others guaranteed by the Borrower;

"Senior Indebtedness" - means all Indebtedness, present or future, which is not expressly subordinated to or ranking *pari passu* with the Loan whether by operation of law or otherwise, in the event of a winding-up, liquidation or dissolution, whether voluntary or involuntary, whether by operation of Law or by reason of insolvency legislation;

5 The end result is that upon the happening of the relevant triggering event, the holders of the SP Debt have contractually agreed that they will be subordinated to Senior Indebtedness. The Trade Creditors assert that there will be untold difficulty in determining what is "borrowed money" as this is an undefined term. With respect, I disagree as not every term has to be defined in an agreement in order to determine its meaning and it would not appear to me to be all that difficult to draw the line if, as and when that becomes necessary.

6 The Trade Creditors also submit that as among the unsecured debt, as the unsecured SP Debt is subordinated to Senior Indebtedness (also unsecured), then the doctrine of subordination requires that the SP Debt be subordinated to all unsecured debt - (that is, not only the Senior Indebtedness but also all unsecured debt). They rely upon what they say is "a fundamental principle of Canadian insolvency law that, excepting only specifically enumerated preferred creditors, all unsecured creditors are entitled to *pro rata* distribution" and that this principle is reflected in s. 141 of the *Bankruptcy and Insolvency Act* ("BIA"):

 

> S.141 Subject to this Act, all claims proved in a bankruptcy shall be paid rateably.

However, this is a CCAA insolvency proceeding not a BIA one. The jurisprudence in CCAA proceedings is that any plans of arrangement are treated as contracts amongst the parties (including the minority voting against) and that the court in a sanction hearing will review the creditor approved plan to see if it is fair, reasonable and equitable, wherein equitable does not necessarily mean equal. See *Alternative Fuel Systems Inc., Re* (2004), 24 Alta. L.R. (4th) 1 (Alta. C.A.); *Sammi Atlas Inc., Re* (1998), 3 C.B.R. (4th) 171 (Ont. Gen. Div. [Commercial List]).

7 The Trade Creditors rely upon *Re Maxwell Communications Corporation PLC*, [1993] 1 W.L.R. 1402 where at pp. 1411-2 in approving the proposed distribution, Vinelott J. concluded that a bilateral subordination between a debtor and a creditor can be effective:

> The question is whether this underlying consideration of public policy should similarly invalidate an agreement between a debtor and a creditor postponing or subordinating the claim of the creditor to the claims of other unsecured creditors and preclude the waiver or subordination of the creditor's claim after the commencement of a bankruptcy or winding up. I do not think that it does. It seems to me plain that after the commencement of a bankruptcy or a winding up a creditor must be entitled to waive his debt just as he is entitled to decline to submit a proof.
>
> If the creditor can waive his right altogether I can see no reason why he should not waive his right to prove, save to the extent of any assets remaining after the debts of other unsecured creditors have been paid in full; . . .
>
> So also, if the creditor can waive his right to prove or agree the postponement of his debt after the commencement of the bankruptcy or winding up, I can see no reason why he should not agree with the debtor that his debt will not be payable or will be postponed or subordinated in the event of a bankruptcy or winding up.
>
> (emphasis by Trade Creditors)

However, I would caution that this quote must be taken in context; similarly for the second Vinelott J. quote. Then in reliance upon Vinelott J.'s views at p. 1416, the Trade Creditors submitted in their factum:

> 20. Accordingly, the Court gave effect to the bilateral subordination provisions as a waiver of the credit to its entitlement to receive any distribution until **all unsecured** creditor claims have been paid in full.
>
> 21. In giving effect to the subordination, the Court distinguished on the facts previous decisions of the English courts that had addressed arrangements that disturbed rateable distribution among unsecured creditors. The Court, however endorsed the fundamental principle that a debtor cannot validly contract with one unsecured creditor for any advantage denied to other unsecured creditors.

Vinelott J. stated at p. 1416:

> [If] the clearance arrangements had had the effect contended for by Air France they would clearly have put a member of the clearance arrangements in a position which would have been better than the position of other unsecured creditors. The arrangements would therefore unquestionably have infringed a fundamental principle of bankruptcy law, which is reflected in but not derived from section 302 or its predecessor, that a creditor cannot validly contract with his debtor that he will enjoy some advantage in a bankruptcy or winding-up which is denied to other creditors.
>
> In my judgment I am not compelled by the decisions of the House of Lords in the *Halesowen* and *British Eagle* cases, or by the decisions of the Court of Appeal in those cases or in *Rolls Razor Ltd. v. Cox*, [1967] 1 Q.B. 552, to conclude that a contract between a company and a creditor, providing for the debt due to the creditor to be subordinated in the insolvent winding up of the company to other unsecured debt, is rendered void by the insolvency legislation.

 

(emphasis by Trade Creditors)

8 The Trade Creditors went on at paras. 23-24 of their factum:

> 23. However, also consistent with the decision of the English Court in *Maxwell* and cases enforcing the policy of rateable distribution among unsecured creditors which were accepted in *Maxwell*, such agreement cannot be enforced to provide an unsecured creditor (or any subset of unsecured creditors) an advantage in an insolvency proceeding which is denied to other unsecured creditors. Put simply, the [SP Debt] holders are free to waive claims if they choose, but neither they nor the debtor can direct that the resulting benefit shall be distributed preferentially to some unsecured creditors and not others.
>
> 24. Treating the holders of [SP Debt] as being subordinated to all unsecured creditors is consistent with key principles of Canadian insolvency law and with the terms of the subordination itself. Such holders should not be entitled to receive any dividend until creditors with "borrowed money" claims are paid in full. As claims arising from "borrowed money"; in the case, are unsecured claims, they are entitled to receive *pro rata* distributions under Air Canada's plan of arrangement with all other unsecured creditors and will be paid in full **only** when all other unsecured claims are paid in full.

9 With respect, I disagree. The Trade Creditors did not bargain or pay for any benefit or advantage in respect of the SP Debt nor are they parties to any agreements in respect thereto and it is important to observe that they have not been designated as third party beneficiaries (nor have they asserted that they were). The cases cited by the Trade Creditors would not appear to me to have much if any relevance to the situation in this case. *Ex parte MacKay* (1873), 8 Ch App 643 dealt with a situation where a creditor had bargained with the debtor for additional rights upon the bankruptcy of that debtor. *British Eagle International Airlines Ltd. v. Compagnie Nationale Air France*, [1975] 1 W.L.R. 780 (HL) involved the applicability of the laws of bankruptcy to the existence of mutual debts existing as of the date of bankruptcy. *Gingras automobile Ltée, Re* (1962), 34 D.L.R. (2d) 751 (S.C.C.) deals with the legal question of paramountcy. *Hamilton and others v. Law Debenture Trustee Ltd. and others*, [2001] 2 BCLC 159 (Ch Div); *Maxwell supra*; *Re British & Commonwealth Holdings PLC (No. 3)*, [1992] 1 WLR 672 (Ch Div) each dealt with instruments that had rights on their face that were subordinated to the rights of <u>all other creditors</u>.

10 Even within a bankruptcy context there is no impediment to a creditor agreeing to subordinate his claim to that of another creditor. See *Rico Enterprises Ltd., Re* (1994), 24 C.B.R. (3d) 309 (B.C. S.C. [In Chambers]) where Tysoe J. observed at pp. 322-3:

> . . . If one creditor subordinates its claim to the claim of another party without subordinating to other claims ranking in priority to the claim of the other party, it is my view that a distribution of the assets of the bankrupt debtor should be made as if there was no subordination except to the extent that the share of the distribution to which the subordinating creditor would otherwise be entitled should be paid to the party in whose favour the subordination was granted.
>
> It is not appropriate to simply take the subordinating creditor out of the class to which it belongs and put it in the class ranking immediately behind the holder of the subordination right. I say this for two reasons. First, the creditors in the same class as the subordinating creditor should not receive the benefit of a subordination agreement to which they are not a party and on which they are not entitled to rely. They would receive a windfall benefit by the removal of the subordinating creditor from their class in the event that there were insufficient monies to fully pay their class because the total indebtedness of the class would be reduced and the pro rata distribution would be increased. Second, if the parties to the subordination agreement turned their minds to it, they would inevitably agree that the subordinating creditor should receive its normal share of the distribution and give it to the party in whose favour the subordination was granted. The party receiving the subordination would agree because it would be paid

  

> a portion of a distribution to a higher class of creditor that it would not otherwise receive and the subordinating creditor would agree because it would not receive the money in either event.

See also *Bank of Montreal v. Dynex Petroleum Ltd.* (1997), 145 D.L.R. (4th) 499 (Alta. Q.B.) at p. 529; (reversed on appeal on other grounds [1999 CarswellAlta 1271 (Alta. C.A.)]); Roy Goode, *Legal Problems of Credit and Security*, 3 rd ed. (Sweet & Maxwell: London, 2003) at p. 55. It would seem to me that a guide-lining principle should be that as discussed in A.R. Keay, *MacPherson's Law of Company Liquidation* (London; Sweet & Maxwell, 2001) at p. 717:

> However, they [the courts] would permit a liquidator to distribute according to an agreement made along the lines of the latter situation providing that to do so would not adversely affect any creditor not a party to the agreement, *i.e.*, creditors not involved in the subordination agreement would not receive less under that agreement than would have been received if distributions had been made on a *pari passu* basis.

See also J.L. Lopes, "Contractual Subordinations and Bankruptcy" (1980), 97 No. 3 *Banking Law Journal*, 204 at p. 206.

> At the conclusion of the bankruptcy proceedings, a dividend is allocated to all unsecured creditors, including the subordinated creditor, on a pro rata basis. The dividend allocated to the subordinated creditor is paid over to the senior creditor, to the extent of its claim, with the subordinated creditor retaining the remainder of the dividend if the senior creditor is paid in full.* This process neither affects the amount of claims against the debtor nor the dividend paid to unsecured creditors. (*See, e.g., *In re* Associated Gas & Elec. Co., 53 F. Supp. 107, 114 (S.D.N.Y. 1943).)

11 It seems to me that what should be looked at with respect to the settlement is the substance and not the form, although it does seem to me that it would be better for form to follow substance. In essence, what the settlement provides for (the settlement to provide some certainty of the result and therefore avoid the uncertainty of the claim by that the SP Debt subordination provision may not be effective vis-à-vis the Senior Indebtedness and the issue of whether the SP Debt would be entitled to a separate class with the possibility of a veto being exercised by this class against a plan of reorganization, otherwise acceptable to the other creditors) is that the SP Debt would receive its rateable share of "proceeds" under the proposed plan but as a result of the agreement between the adherents to the settlement, then the SP Debt adherents would transfer 74% of their proceeds to the benefit of the Senior Indebtedness and retain 26%. It would also appear that the same result could obtain with a partial assignment of SP Debt claims or a declaration of trust in favour of the Senior Indebtedness, with the *quid pro quo* being that there be no subordination as to the remaining 26% beneficially owned by the holders of the SP Debt.

12 There was no problem with this type of subordination arrangement in *Horne v. Chester & Fein Property Developments Pty Ltd. and Ors* (1986), 11 ACLR 485 (Vic SC) at pp. 489-90 where Southwell J. stated:

> In the speech of Viscount Dilhorne, there is a discussion of a number of authorities, of which "the weight of opinion expressed ... appears to me to be in favour of the conclusion that it is not possible to contract out of s 31". However, there, and, so far as I have seen in most other relevant cases, the term "contract out" is used in circumstances where the contract relied upon is one, the performance of which, upon later insolvency, would adversely affect other creditors who were not parties to the contract. Viscount Dilhorne referred with approval at 805 to *dicta* of Hallett J. in *Victoria Products Ltd. v. Tosh & Co. Ltd.* (1940), 165 L.T. 78 where His Honour said that "... an attempt to leave outside that process some particular item is one which should be regarded as against the policy of the insolvency laws ..."
>
> Repeatedly, over the years, "the policy of the insolvency laws" has formed the basis of decision. That policy, as it appears to me, was never intended to alter the rights and obligations of parties freely entering into a contract, unless the performance of the contract would, upon insolvency, adversely affect the right of strangers to the contract. Authority for that proposition is to be found in *Ex parte Holthausen*; *Re Scheibler* (1874) LR 9 Ch App 722 at 726-7 (referred to by Lord Morris in his dissenting speech in *British Eagle* at 770-1).

  

13 In *Canada Deposit Insurance Corp. v. Canadian Commercial Bank* [(December 15, 1993), Wachowich J. (Alta. Q.B.)] (unreported decision of Wachowich J. CQBA released December 15, 1993), the governments of Canada and Alberta waived their Crown priority on insolvency in favour of all other unsecured creditors, reducing themselves to *pari passu* ranking. But the CDIC also waived any Crown priority that it may have arising from its status as an agent of the government of Canada and it also subordinated its claim in favour of some but not all of the other unsecured creditors (including trade creditors). As put by the Bayerische Landesbank group in their factum at para. 65:

> 65. Justice Wachowich correctly dismissed the objection made to him that the selective nature of the subordination offended the *pari passu* principle. He approved a distribution in which it was first determined what the ordinary shares of all unsecured creditors were and then the *pari passu* recovery by CDIC attributable to its claim was redirected to those creditors to whom CDIC (here, the [SP Debt] holders), the corresponding enhanced recovery went to those unsecured creditors who were intended to enjoy the benefit of the subordination covenant (here, holders of the Senior Indebtedness) and the effect on the other unsecured creditors (here, the trades) was neutral.

14 In the end result I do not see that there is any problem with the SP Debt being selectively subordinated to the Senior Indebtedness. This subordination to that "borrowed money" does not result in the SP Debt being subordinated to all the unsecured debt, Senior Indebtedness and non-Senior Indebtedness alike.

15 With respect to the right to vote, I do not see that the fact that there is a subordination takes away or detracts from the right to vote by holders of the SP Debt. See *Menegon v. Philip Services Corp.* (Ont. S.C.J. [Commercial List]) at paras. 38, 53. At para. 21 of *Uniforêt inc., Re*, [2003] Q.J. No. 9328 (C.S. Que.), Tingley J. stated:

> 21. For a plan of arrangement to succeed, an insolvent company must secure the approval of all classes of its creditors, even those who have subordinated their claims to all other creditors, as is the case with the debenture holders.

16 The Trade Creditors motion is dismissed.

17 The issue of whether the AC Applicants can incorporate the terms of the subject settlement or some equivalent thereof in a Plan to be proposed is in my view a matter for them to decide, but in general, I see no impediment to their doing so provided that they take into account all relevant factors.

18 That leaves the issue of the position of the DM Bonds in light of the fact that s. 8(2) of their Indenture does not refer to "reorganization" in the same way as the other issues of the SP Debt does. Again, one must look at this provision in context. Allow me to set out the provisions of s. 8(1)(2)(5) and (7):

> 8. Subordination and Status; Listing
>
> > (1) The payment of principal and interest on the Bonds and Coupons is hereby <u>expressly subordinated, to the extent and in the manner</u> hereinafter set forth, in right of payment to the prior payments in full of all Senior Indebtedness of the Borrower. The term "Senior Indebtedness" shall mean all indebtedness, present or future, which is not expressly subordinated to or ranking *pari passu* with the Bonds, whether by operation of law or otherwise, in the event of a winding-up, liquidation or dissolution, whether voluntary or involuntary, whether by operation of law or by reason of insolvency legislation. The term "Indebtedness" shall mean the principal, premium, if any, and unpaid interest (including interest accrued after the commencement of any reorganization or bankruptcy proceeding) on any indebtedness of the Borrower for borrowed money, whether evidence by a bond, debenture, note or other evidence of indebtedness whether secured or unsecured, including indebtedness for borrowed money of others guaranteed by the Borrower and including the Bonds and Coupons contemplated hereby.
> >
> > (emphasis added)

  

(2) Upon any winding-up, liquidation or dissolution of the Borrower, whether in bankruptcy, insolvency, receivership or other proceedings including special Act of Parliament or upon an assignment for the benefit of creditors or any other sequestering of the assets and liabilities of the Borrower or otherwise,

(a) the holders of all Senior Indebtedness shall be entitled to receive payment in full of all sums on account of Senior Indebtedness (including payment of or provision for any unmatured, contingent or unliquidated Senior Indebtedness) before the holders of Bonds or Coupons are entitled to receive any payment of interest or principal; and

(b) any payment or distribution of assets of the Borrower of any kind or character, whether in cash, property or securities, to which the holder of Bonds or Coupons would be entitled except for the provisions of this § 8 shall be paid by the liquidation trustee or agent or other person making such payment or distribution, whether a trustee in bankruptcy, a receiver or liquidating trustee or otherwise, directly to the holders of Senior Indebtedness or their representative or representatives or to the trustee or trustees under any indenture under which any instrument evidencing any of such Senior Indebtedness may have been issued, rateably according to the aggregate amounts remaining unpaid on account of the principal of, premium, if any, and interest on the Senior Indebtedness, held or represented by each, to the extent necessary to make payment in full of all Senior Indebtedness remaining unpaid, after giving effect to any concurrent payment or distribution to the holders of such Senior Indebtedness; and

(c) subject to the payment in full of all due Senior Indebtedness holders of Bonds or Coupons shall be subrogated *pro rata* (based on respective amounts paid for the benefit of the holders of Senior Indebtedness) with the holder of other Indebtedness to the rights of the holders of Senior Indebtedness to receive payments or distributions of cash, property or securities of the Borrower applicable to Senior Indebtedness until the Bonds and Coupons shall be paid in full and no such payments or distributions to the holders of Bonds or Coupons of cash, property or securities otherwise distributable to the holders of Senior Indebtedness shall, as between the Borrower, its creditors other than the holders of Senior Indebtedness, and the holders of Bonds or Coupons be deemed to be a payment by the Borrower to the holders of Bonds or Coupons, or for their account. It is understood that the provisions of this § 8 are and are intended solely for the purpose of defining the relative rights of the holders of Bonds or Coupons and the holders of other *pari passu* Indebtedness, on the one hand, and the holders of Senior Indebtedness, on the other hand.

(5) No payment by the Borrower on the Bonds or Coupons (whether upon redemption or repurchase, or otherwise) shall be made if, at the due time o f such payment or immediately after giving effect thereto, (a) there shall exist a default in the payment of principal, premium, if any, sinking fund or interest with respect to any Senior Indebtedness, or (b) there shall have occurred an event of default (other than a default in the payment of principal, premium, if any, sinking fund or interest) with respect to any Senior Indebtedness, as defined therein or in the instrument under which the same is outstanding, permitting the holders thereof or any trustee under any such instrument to accelerate the maturity thereof, and such event of default shall not have been cured or waived or shall not have ceased to exist (except payments made if the Bonds are redeemed or acquired prior to the happening of such default or event of default).

(7) The Borrower undertakes vis-à-vis the Trustee for the benefit of the holders of Bonds and Coupons that until such time as the Bonds or Coupons have been completely repaid the Borrower will ensure that the Bonds rank and will rank *pari passu* with all unsecured and subordinated Indebtedness of the Borrower other than Indebtedness preferred by law.

19 It is not instantly obvious as to which provision "hereafter" refers to as there is no specific section reference in the same way as is specified in sections 1(2), 2(1), 3(1), 3(2), 9(3) and 10(3) of the DM Bond terms. It was posited by the Bayerische Landesbank group that "hereafter" may refer to (i) the remainder of s. 8(1); (ii) s. 8(2); (iii) the entire

 

subsequent balance of s. 8; or (iv) the entire balance of the DM Bond terms. As the balance of s. 8(1) consists of definitions of "Senior Indebtedness" and "Indebtedness", this would speak to the "extent" of the subordination of the DM Bonds but would not address the manner in which they are subordinated.

20 Section 8 does contain a description of how distributions are to be applied as between holders of Senior Indebtedness and holders of the DM Bonds in the event of AC being wound-up, liquidated or dissolved and there is a distribution of its assets. Thus s. 8(2) can be read as addressing the "manner" of the subordination in those particular circumstances of such a winding-up, liquidation or dissolution. However is s. 8(2) the exclusive trigger in respect of subordination? It should be kept in mind that there is no "magic words or formula" to invoke a subordination. As well, as indicated above, there are other references to specific provisions of the terms so as to direct the reader to a specific spot. It should be observed that s. 8(2) is not the only provision in the balance of s. 8 which deals with the subject of subordination as s. 8(3), (4), (5), (6) and (7) contain additional procedural or other provisions addressing in some sense the "manner" of subordination. Is there a conflict with s. 8(5) or (7) if "hereafter" refers only to s. 8(1) and (2)?

21 Section 8(5) provides that the subordination of the DM Bonds is effective if AC fails to make any payment to any holder of the Senior Indebtedness, when due, without any reference to whether or not this default in timely payment gives rise to, or occurs in the course of, any form of insolvency proceedings. There has been a default in the payment of interest due on the Senior Indebtedness since some time prior to the CCAA filing in April, 2003. The DM Bondholders assert that this default will be cured as it is expected that the amounts due on the Senior Indebtedness will be satisfied upon implementation of a Sanctioned Plan (and in this respect I note that there is no time limit for cure to take place contained in s. 8(5)). However this presupposes that the Plan mechanism would indeed cure the default. However in the context of s. 8(5), I do not see that such compromise of the right of holders of Senior Indebtedness to be paid acts as a cure which would otherwise inactivate the form of subordination which s. 8(5) provides. Thus it would seem to me that at the present time, the failure to pay amounts due on the Senior Indebtedness has caused a default which has triggered the subordination provisions of s. 8(5). This trigger aspect is not dependent upon there being a "reorganization".

22 Section 8(7) provides that the DM Bonds are to rank *pari passu* with all unsecured subordination Indebtedness of AC which would include the other issues of SP Debt. If the DM Bonds were not to rank equally with the rest of the SP Debt, then s. 8(7) would be rendered meaningless.

23 It therefore seems to me that the DM Bonds are to be treated at this time as SP Debt which is to be treated in the same way as the other issues of SP Debt which are all presently subordinated to the Senior Indebtedness.

24 Orders to issue accordingly.

*Motion dismissed.*

Footnotes

* A corrigendum issued by the court on June 18, 2004 has been incorporated herein.

TAB 3

1994 CarswellBC 608
British Columbia Supreme Court, In Bankruptcy

Rico Enterprises Ltd., Re

1994 CarswellBC 608, [1994] B.C.W.L.D. 726, [1994] B.C.J. No. 3019, 24 C.B.R. (3d) 309, 45 A.C.W.S. (3d) 1013, 92 B.C.L.R. (2d) 67

# Re bankruptcy of RICO ENTERPRISES LTD.

Tysoe J. [in Chambers]

Heard: February 16, 1994
Judgment: February 25, 1994
Docket: Doc. Vancouver 144151 VA/92

Counsel: *Peter A. Spencer*, for trustee in bankruptcy, Deloitte & Touche Inc.
*Arthur L. Edgson*, for Johann Schupp and four other holders of promissory notes.
*John F. Grieve*, for Wenzel Enterprises Ltd. and Helmut Wenzel.
*William D. Riley*, for Rico Enterprises (Vancouver) Ltd. and Hans Rieder.

Subject: Corporate and Commercial; Insolvency

Application by trustee in bankruptcy for directions regarding distribution of dividends to creditors of bankrupt.

***Tysoe J.* [In Chambers]:**

1 The Trustee in Bankruptcy has applied for directions relating to the distribution of dividends to the creditors of Rico Enterprises Ltd. (the "Bankrupt"). The issues to be resolved relate to the priorities between various creditors and the existence of an outstanding action which could affect the categorization and priority of moneys owed to a group of creditors who are the plaintiffs in that action.

**Facts**

2 The Bankrupt was an investment vehicle for the construction and operation of two restaurants at Expo '92 in Seville, Spain. The persons who invested in the enterprise purchased units in numbered companies which, in turn, purchased units in the Bankrupt. Each unit consisted of shares and debt, with a nominal amount of the purchase price being allocated to the shares and the balance being allocated to the debt. Thus, an investor would receive shares in the numbered company plus a promissory note from the numbered company, and the numbered company would receive shares in and a promissory note from the Bankrupt. The investment was apparently structured in this manner for income tax reasons. Letters of credit were also involved but they were all drawn upon and, for the purpose of this application, they can be treated the same as cash advances made in exchange for promissory notes.

3 The numbered companies through which the initial group of individuals invested, which became known as the First Round Investors, contributed approximately $4 million to the project in the form of cash and letters of credit. Expo '92 was to open on April 20, 1992 and it became apparent by late 1991 or early 1992 that there were significant cost overruns and that a further capital injection of at least $2 million was required to complete construction of the restaurants. If additional financing could not be obtained, the restaurants would not open and, instead of the generous profits that were anticipated as a result of the success of similar restaurants at Expo '86 in Vancouver, the project would be a financial disaster with all the First Round Investors and creditors (except the banks holding the letters of credit) losing all of their

 

monies. The situation was desperate, although the outlook for the project was still optimistic if the construction of the restaurants could be finished prior to the opening of the fair.

4 On February 17, 1992 the Bankrupt received an investment proposal (the "Proposal") from 419776 British Columbia Ltd. ("Newco"). It proposed that Newco would provide financing of up to $2,160,000 for 18 units in the projects. There were numerous terms and conditions of the financing, including the payment of a $432,000 bonus to Newco, the right of Newco to appoint two members of the Bankrupt's board of directors and the substitution of two key officers with persons selected by Newco. The proposal also contained the following three paragraphs:

> 6. All profits (the definition of which shall be approved by Newco) of the Company shall be dispersed to those parties and in the order set out below:
>
> (a) Newco shall receive the Bonus;
>
> (b) Newco shall be repaid of all (sic) of its initial investment;
>
> (c) loans shall be paid as approved by the new Board of Directors of Rico;
>
> (d) accrued wages and salaries of related parties and invoices of Spanish Ventures and its principals all as approved and accepted by the new Board of Directors of Rico;
>
> (e) all remaining loans of the Existing Investors shall be repaid together with interest of 12% per annum for cash loans and 1% per annum for letter of credit loans; and
>
> (f) the remaining profits shall be shared by all investors equally.
>
> . . . . .
>
> 10. The terms and conditions of this proposal must be approved by a majority of the Existing Investors at a meeting of the Existing Investors called for this purpose.
>
> 11. This is a proposal only and shall be subject to preparation of formal documentation.

5 A meeting of the individuals who invested through the First Round Investors (who presumably were the group referred to in the proposal as the Existing Investors) was held on February 17, 1992 to consider the Proposal. The meeting approved the Proposal. Some of the individual investors did not attend the meeting and at least one of the individual investors who did attend voted against the approval of the Proposal.

6 The new investment did not go forward on the basis contemplated by the Proposal. Further investments in the form of cash advances and the posting of letters of credit in the aggregate of approximately $2.6 million were made but the investments were not made through the company that made the Proposal, 419776 British Columbia Ltd., and there was not the type of formal documentation one would have expected from paragraph 11 of the Proposal. The investments were made through six numbered companies, which have become known as the Second Round Investors. Four of the Second Round Investors were also numbered companies within the group of the First Round Investors. In terms of the individual investors, five of the 18 units were purchased by previous investors and the other 13 units were acquired by persons who were new to the project.

7 The only documentation relating to the new investment were the shares, promissory note and letters of credit which comprised each unit, an offering memorandum that had a copy of the Proposal included within it and two agreements which I will describe shortly.

8 At the time of the investment made by the Second Round Investors, the Bankrupt had several types of creditors. I have already referred to the First Round Investors and the bankers which held letters of credit issued by the bankers of the First Round Investors. The Bankrupt also had normal trade creditors, some of which were related to the Bankrupt in the

  

sense that the trade creditor or its principal had invested in the project through the First Round Investors. Approximately $500,000 was owed to the Bankrupt's directors or their associated companies on account of loan advances made by them. The Bankrupt also owed in excess of $100,000 in respect of loans made to it by persons who had not invested in the project as shareholders.

9 One of the individuals who invested in the project through the First Round Investors was Mr. Hans Rieder who was the principal of a company called Rico Enterprises (Vancouver) Ltd. That company was owed $63,000 for consulting services and $240,000 for loans made to the Bankrupt. Rico Enterprises (Vancouver) Ltd. and Mr. Rieder (who I shall collectively refer to as "Rieder") signed an agreement with the Bankrupt around the time of the second round of investments. The agreement was dated February 21, 1992 but it was signed in the first part of March 1992. In the agreement Rieder agreed that it would not pursue its claims against Rico by way of court proceedings prior to October 12, 1992, which was the end of Expo '92. The agreement then contained the following two paragraphs:

> 2. It is further agreed that in consideration of the foregoing agreement to postpone any claims, such claims shall be settled as provided herein prior to distribution of profits in respect of the remaining loans of the Existing Investors (as prescribed in paragraph 6(e) of the proposal dated February 17, 1992).
>
> 3. It is further agreed that the terms of the letter of Clark, Wilson to Edwards, Kenny & Bray dated March 2, 1992 attached hereto as Schedule "A" shall form part of this Agreement, provided that the sum of $63,000.00 plus accrued interest referred to therein shall be deemed to be accrued wages for the purposes of distribution of profits (as prescribed in paragraph 6(d) of the proposal dated February 17, 1992).

The attached letter from Clark, Wilson stated that Mr. Rieder would release the Bankrupt from all claims related to his employment and termination of employment in exchange for payment of $63,000 plus interest and that Mr. Rieder would make himself available as a consultant for the project for up to a maximum of 20 days at a rate of $250 a day.

10 Another one of the investors who had invested in the project through the First Round Investors was Mr. Helmut Wenzel who was the principal of a company called Wenzel Enterprises Ltd. That company was owed $120,000 for construction services and $203,000 for loans made to the Bankrupt. Mr. Wenzel and Wenzel Enterprises Ltd. (who I will collectively refer to as "Wenzel") also signed an agreement dated March 3, 1992 with the Bankrupt. Similar to the Rieder agreement, it provided that Wenzel would not pursue its claims against the Bankrupt by way of court proceedings prior to October 12, 1992. The agreement incorporated a Memorandum of Understanding that had been prepared by a solicitor acting for Wenzel. Paragraph C of the Memorandum of Understanding recited the $120,000 amount owing to Wenzel for construction services plus the interest owing on that amount and continued as follows:

> No payments have been made whatsoever in respect of those amounts and the same will become due and will be paid, as if the same were accrued wages, according to the order of payments set out in paragraph 6 of the letter of offer dated February 17, 1992 from 419776 B.C. Ltd. which is attached to and forms part of the Offering Memorandum.

Paragraph H(a) of the Memorandum of Understanding recited the loans made by Wenzel to the Bankrupt and continued as follows:

> The loans referred to in this paragraph (a) shall be paid not later than the loans referred to in the paragraph 6(c) of the letter dated February 17, 1992 from 419776 B.C. Ltd. which is attached to and forms part of the Offering Memorandum together with all accrued interest.

11 No other documentation regarding the priorities contemplated in paragraph 6 of the Proposal was signed around the time of the investment made through the Second Round Investors, but two parties have sent letters to the Trustee in Bankruptcy in relation to the priorities of their claims. The first letter was sent by Mr. Doug Schafer, the principal of a company called T.K. Holdings Ltd. which was owed $57,500 for "wages" and approximately $10,000 on account of loans made by it to the Bankrupt. In his letter dated March 29, 1993 Mr. Schafer stated the following with respect to the priorities of the wages and loan advances:

 

> On February 25, 1992 I met with Harry and Greg and agreed that I would defer my accrued wages up to February 15th totalling ($57,500.00) plus accrued interest until the new investors received their investment plus bonus.
>
> . . . . .
>
> With respect to the promissory note holders, these funds were advanced to assist with cash-shortfalls and were not part of any investment. All note holders were advised they would be paid before any disbursements to investors.

Mr. Schafer also stated in his letter that "it was always understood that trade creditors would be paid before investors".

12 The other relevant letter, which was sent to the Trustee's counsel, was a letter from Davis & Company dated April 8, 1993. Davis & Company provided legal services to the Bankrupt and one of its partners was an investor and a director of the Bankrupt. Davis & Company had previously filed a proof of claim in the amount of $123,476.20 without differentiating between the legal costs incurred prior to the second round of investments and the legal costs incurred after the final investments. Davis & Company had apparently also sent a letter to counsel for the Trustee maintaining that its claim should be treated as a normal claim of a trade creditor. The letter dated April 8, 1993 indicated that the earlier letter had been in error and it contained the following statements:

> All the time and charges prior to February 17, 1992 were subordinated whereas the time incurred after that date was not ... The amount owing as at February 17, 1992 is $57,675.39 and we agree that this amount is subordinated to the claims of the Second Round Investors.
>
> . . . . .
>
> As I indicated to you, the agreement that was reached between Davis & Company and Rico Enterprises Ltd. was to subordinate their previous fees and disbursements providing future fees and disbursements were paid in priority to the claims of all Investors.

13 As is obvious from its bankruptcy, the Bankrupt was not successful in the operation of the two restaurants at Expo '92. The construction of the restaurants was completed prior to the opening of Expo '92 but the businesses did not generate any profits. The Bankrupt filed a proposal under the *Bankruptcy and Insolvency Act* at the conclusion of the fair in October 1992. The proposal was rejected by the creditors in April 1993 and the bankruptcy ensued. The Trustee has received funds in excess of $800,000 with the recovery being mainly from the return of deposits that had been lodged by the Bankrupt.

14 After it was apparent that the project had not been successful, certain of the investors who invested through the First Round Investors (the "Robson Group") commenced an action against the Bankrupt and others claiming rescission of their transactions. Statements of Defence and Third Party Notices were filed in the action. No further steps have been taken since June 1993.

**Discussion**

15 None of the First Round Investors or the Second Round Investors attended at the hearing of the application. Counsel for the Trustee advised me that these Investors do not dispute that they fall under s. 139 of the *Bankruptcy and Insolvency Act* according to the criteria discussed in *Laronge Realty Ltd. v. Golconda Investments Ltd.* [1] I agree with the submission of the Trustee's counsel in this regard and I need not elaborate on the facts relating to this aspect. Hence, by virtue of s. 139, the two groups of investors are not entitled to be paid the amounts owing to them under the promissory notes until the claims of all other creditors of the Bankrupt have been satisfied.

16 In their action the Robson Group is claiming entitlement to rescind their investment transactions. The Trustee is concerned that if the Robson Group is successful in its rescission claim after the Trustee has made a distribution on the basis that all of the loans made by the First Round Investors fall within s. 139, the Robson Group could make a claim against the Trustee and say that the monies owed to the First Round Investors through which they invested no longer

 

fall within s. 139. I authorize and direct the Trustee to make distributions to the creditors of the Bankrupt on the basis that the monies owing to all of the First Round Investors do fall within s. 139 unless, prior to any such distributions, the Robson Group obtains an Order of this Court preventing any such distributions or is successful in its rescission claim and had notified the Trustee. The Trustee may apply for further directions if the Robson Group is successful in its rescission claim before the monies available for the Bankrupt's creditors have been fully distributed. I also direct the Trustee to advise the Robson Group of my ruling in this regard at least 15 days prior to making the first distribution to the creditors.

17 On its application for directions the Trustee proposes to the Court that the priorities contemplated in paragraph 6 of the Proposal be recognized and that, after payment of expenses and preferred claims, the available monies be distributed as follows:

(a) firstly, in payment in full of (i) the claims of the trade creditors who were not investors in the project, (ii) the claims of the trade creditors who were investors to the extent that they arose after February 17, 1992 and (iii) the claims of the lenders who were not investors;

(b) secondly, the balance to be paid to or at the direction of the Second Round Investors.

18 This proposed method of distribution would see approximately $225,000 paid to the trade creditors, $142,000 paid to the non-investor lenders and the balance in the neighbourhood of $400,000 paid to or at the direction of the Second Round Investors. The following groups would receive nothing under the Trustee's proposed distribution:

(a) trade creditors who were investors to the extent that their claims arose before February 17, 1992 (namely, Rieder, Wenzel, T.K. Holdings Ltd. and Davis & Company who are owed an aggregate of approximately $350,000 under this category);

(b) directors who made loans to the Bankrupt (namely, Rieder, Wenzel, T.K. Holdings Ltd. and Hans Speck who are owed approximately $540,000 under this category).

19 Counsel for the Trustee urged me to find that there was an agreement between all affected parties along the lines of the order of priority set forth in paragraph 6 of the Proposal. Although I respect the views of the Trustee, I am unable to accede to its proposed method of distribution.

20 The persons who made their investments through the Second Round Investors appear to have held the view that a majority vote at a meeting of the individuals who invested through the First Round Investors would be sufficient to bind all affected creditors to the provisions of paragraph 6 of the Proposal. This view was misconceived and it is unfortunate that these persons made their investments while under such a misconception.

21 It is uncertain whether the vote at the meeting of the individuals who invested through the First Round Investors was binding on all of the First Round Investors irrespective of whether the individuals attended at the meeting or voted against the Proposal. It can be argued that the shareholders of each of the First Round Investors indicated their majority wishes at the meeting and that the majority votes at the meetings constituted agreement on behalf of each of the First Round Investors to the priorities set out in paragraph 6 of the Proposal. There was some evidence that at least one shareholder at the meeting believed that they were agreeing to the proposed transaction in principle only.

22 However that may be, it is clear that the vote of the meeting was not binding on the creditors of the Bankrupt who happened to be represented at the meeting. A vote at a meeting of shareholders of a company cannot be automatically binding on creditors of the company on the basis of commonality between some shareholders and some creditors. A person voting at a shareholders' meeting cannot be taken as agreeing to the subject matter of the vote in their capacity as a rep resentative of a creditor of the company unless it is expressly stipulated to be the case. Indeed, this was recognized in the present case as a result of the agreement with Wenzel who attended the February 17 meeting. If he was to be bound in all capacities as a result of the February 17 meeting, it would not have been necessary to have Wenzel enter into the March 3, 1992 agreement with the Bankrupt.

 

23 The Proposal itself is not an enforceable agreement for several reasons. First, it is stated on its face to be a proposal only and subject to formal documentation. Second, the party who made the proposal, 419776 British Columbia Ltd., did not invest monies in the Bankrupt. Third, there are at least two uncertainties that are not capable of clarification by the Court. The term "profits" was never defined. In view of the fact that paragraph 6 of the Proposal mixes the ranking of debt and equity, the Court is not in a position to say that any particular definition of "profits" was intended by the parties because a traditional definition of "profits" is based on the payment of expenses in priority to the payment of equity. Also, the definition of the term was subject to the approval of Newco and there is no evidence as to what definition may have been acceptable to it. Further, clause (c) of paragraph 6 refers to loans generally but the evidence indicates that there was an intention to give different treatment to loans made by directors and loans made by non-investors. The formal documentation contemplated by paragraph 11 would presumably have dealt with these points and, while the Court will generally fill out the terms of an agreement to make it enforceable, the Court should not endeavour to write the agreement on behalf of the parties when critical aspects are not known with any certainty.

24 Counsel for the Trustee submitted that although the Proposal itself may not be enforceable, I should find that the parties agreed to the priorities contained in paragraph 6 of the Proposal. I am unable to make such a finding because there is no evidence of such an agreement being reached. The only evidence before me in relation to priorities are the fact that a meeting of the individual investors approved the Proposal and the existence of the two agreements and the concessions in the two letters that I have described. It appears that the Second Round Investors proceeded on the erroneous assumption that all necessary parties had agreed to the priority contained in the Proposal.

25 In addition, the wording of s. 139 of the *Bankruptcy and Insolvency Act* should be considered. The relevant portion of the section is as follows:

> Where a lender advances money to a borrower ... under a contract with the borrower that the lender ... shall receive a share of the profits ... and the borrower subsequently becomes bankrupt, the lender of the money is not entitled to recover anything in respect of the loan until the claims of all other creditors of the borrower have been satisfied.

This section must have been intended to apply notwithstanding a contrary agreement between the lender and the bankrupt. The agreement by the bankrupt to repay the monies as a loan carries with it the implication that the monies will rank in priority equally with the unsecured debt of the bankrupt. That is itself a contrary agreement which Parliament clearly intended to override. This means that in the present situation, an agreement between the Second Round Investors and the Bankrupt along the lines of paragraph 6 of the Proposal is subject to the provisions of s. 139. In other words, if there was an agreement between the Second Round Investors and the Bankrupt to the effect of paragraph 6, s. 139 would render unenforceable the priority given to the Second Round Investors over the Bankrupt's unsecured creditors.

26 It may be that the Second Round Investors have priority agreements with creditors of the Bankrupt and the First Round Investors, and they may be able to enforce such agreements in separate proceedings. It is my view, however, that the distribution by the Trustee should only be affected by agreements between the Bankrupt and its creditors, and by agreements between creditors that are conceded. There would be no point in having the Trustee distribute monies to one creditor when it is admitted by that creditor that the monies should be paid to another creditor. In support of my view, I refer to the decision of the First Appellate Division of the Ontario Supreme Court in *Re Orzy*[2] where Ferguson J.A. said the following:

> ... the practice in bankruptcy does not permit of the adjustment of the rights and privileges of creditors *inter se* but only the rights, privileges and preferences of creditors as against the insolvent and his estate ... the reason or principle governing being that bankruptcy proceedings are designed to administer the rights of creditors of the estate as against the debtor and his estate, and therefore the Court may not in that administration be delayed or hindered by being called upon to determine questions between creditors or between a creditor and another person such as assignee of a creditor, or as here a question as to whether or not one creditor is estopped from taking a dividend from the insolvent estate to the prejudice of another.

 

27 I turn now to the interpretation and effect of the two agreements that were entered into with the Bankrupt and the effect of the concessions contained in the letters from Mr. Schafer and Davis & Company.

28 Each of the Rieder and Wenzel agreements have separate paragraphs dealing with the monies owing on account of loans and the monies owing in respect of consulting/construction services. I will address the corresponding paragraphs in the two agreements at the same time.

29 The language in the Rieder and Wenzel agreements in relation to the loans owing to them is not sufficient to postpone the loans in priority to the monies owing to the Second Round Investors or any of the Bankrupt's creditors. Indeed, paragraph 2 of the Rieder agreement was contemplated to be in favour of Rieder because it was stated to be in consideration of Rieder agreeing in the previous paragraph that it would not pursue its claims against the Bankrupt prior to October 12, 1992. Paragraph 2 was an assurance to Rieder that although it had agreed not to pursue its claims for a specified period of time, it would be paid prior to the distribution of any monies to the First Round Investors. The paragraph does not say, either expressly or by necessary implication, that Rieder has postponed its claims to the rights of the Second Round Investors, the trade creditors or other parties who made loans to the Bankrupt.

30 If it was the intention of the draftsperson of the Rieder agreement to bind Rieder to the priority provisions of the proposal, they did not accomplish this intention. But it is doubtful that this was the intention of the draftsperson. Paragraph 2 of the Rieder agreement states the claims will be settled prior to distribution of profits in payment of the loans owing to the First Round Investors (as opposed to being paid at the same time as the loans referred to in clause 6(c) of the Proposal). There is no statement that the loans owing to Rieder would not be paid prior to the repayment of the new investment and bonus or any other amount. It would have been easy for the draftsperson of the Rieder agreement to state that Rieder agreed to be bound by the order of priority contained in paragraph 6 of the Proposal and that Rieder postponed its claim accordingly. There is no equivalent language in the Rieder agreement and one must conclude that the draftsperson had a different intention in drafting the language as they did.

31 Similarly, paragraph H(a) of the Memorandum of Understanding attached to the Wenzel agreement states that the loans owing to Wenzel will be paid not later than the loans referred to in clause 6(c) of the Proposal. There is no statement that the loans are not to be repaid prior to the new investment and bonus or any other amount. The language in paragraph H(a) of the Memorandum of Understanding is not sufficient to create a postponement or subordination of the loans owed to Wenzel.

32 The draftspersons of the Rieder agreement and the Memorandum of Understanding attached to the Wenzel agreement appreciated that monies owing to the two companies for consulting and construction services were not wages or salaries. The draftsperson of the Rieder agreement therefore used the words: "[the monies owing for the consulting services] shall be deemed to be accrued wages for the purpose of distribution of profits (as prescribed in paragraph 6(d) of the proposal dated February 17, 1992)". The draftsperson of the Wenzel Memorandum of Understanding used the words: "[the monies owing for the construction services] will become due and will be paid, as if the same were accrued wages, according to the order of payments set out in paragraph 6 of the letter of offer dated February 17, 1992 from 419776 B. C. Ltd.". The issue is whether this language is enforceable to subordinate the claims for consulting/construction services to the claims of the Second Round Investors or any other creditor.

33 I have found that paragraph 6 of the Proposal is not enforceable because, among other reasons, there are at least two uncertainties that are incapable of clarification by the Court. The Court cannot realistically determine what the parties meant by the term "profits" and the approval of 419776 British Columbia Ltd. to any definition is absent. Also, the evidence indicates that there is uncertainty regarding the loans referred to in clause 6(c). If paragraph 6 of the Proposal itself is unenforceable for these reasons, it follows that paragraph 3 of the Rieder agreement and paragraph C of the Wenzel Memorandum of Understanding, which appear to be attempts to incorporate the order of payment set out in paragraph 6 for the purposes of the payment of the consulting/construction services, are unenforceable for the same reasons.

  

34 Also, there is an argument that can be made to the effect that in addition to overriding agreements between a bankrupt and its equity type lenders, s. 139 overrides agreements between a bankrupt and its other creditors that would give equity type lenders a priority higher than the priority stipulated by s. 139 (such as the Rieder and Wenzel agreements). I will not address the argument at this time for reasons that will become apparent.

35 Even if the Court was in a position to formulate a definition for the term "profits", it would presumably bear a resemblance to the statement that the profits are the difference between the revenues and the expenses of the Bankrupt over a certain period of time. However, the Bankrupt's revenues never exceeded its expenses with the result that there is no profit to distribute. The language in paragraph 6 of the Proposal only deals with the distribution of profits and it does not address the present situation of a financial failure. If the new investors had directed their minds to the point, they may have insisted that the order of priorities apply to any distribution of the Bankrupt's assets but I cannot infer that Rieder or Wenzel would definitely have agreed.

36 The final two matters requiring consideration are the conces sions made by T.K. Holdings Ltd. and Davis & Company in the letters to the Trustee and its counsel. Neither T.K. Holdings Ltd. nor Davis & Company attended at the hearing of the application and it may not have occurred to them that there is an argument that their agreements with the Bankrupt may be overridden by the provisions of s. 139 of the *Bankruptcy Act*. Their agreements regarding subordination would not be overridden by s. 139 if they made the agreements directly with the Second Round Investors because the agreements could be enforced between the parties after the making of a distribution that did not violate s. 139. From a purist's point of view, it could be said that the trustee should make the distribution in compliance with s. 139 and leave it to the parties to the subordination agreement to deal with the priorities between them. But if the subordinating creditor concedes that it has subordinated its claim to the claim of a lender which falls within s. 139, I see no reason why the trustee could not pay the share of the subordinating creditor directly to the s. 139 lender as if the subordinating creditor had assigned its claim to the lender.

37 However, in the present case, the two letters from Mr. Schafer and Davis & Company appear to state that the agreements were made with the Bankrupt. Accordingly, I give them leave to make an application for the purpose of advancing an agreement that s. 139 overrides their agreements. I do not expect they will definitely make such an application because I appreciate that they may also have made their agreements with the Second Round Investors. In addition, even if there is a potential argument that their agreements with the Bankrupt are not binding in view of s. 139, they may feel a moral commitment to the Second Round Investors that they should not take the portion of the distribution allocable to their pre-February 17, 1992 services in priority to the Second Round Investors.

38 In the event that the agreements conceded to have been made by T.K. Holdings Ltd. and Davis & Company are not overridden by s. 139, their claims are subordinated to the claims of the Second Round Investors. There is no evidence that they subordinated their claims to all other claims ranking in priority to the claims of the Second Round Investors and that result does not automatically flow from a subordination to the Second Round Investors. If one creditor subordinates its claim to the claim of another party without subordinating to other claims ranking in priority to the claim of the other party, it is my view that a distribution of the assets of the bankrupt debtor should be made as if there was no subordination except to the extent that the share of the distribution to which the subordinating creditor would otherwise be entitled should be paid to the party in whose favour the subordination was granted.

39 It is not appropriate to simply take the subordinating creditor out of the class to which it belongs and put it in the class ranking im mediately behind the holder of the subordination right. I say this for two reasons. First, the creditors in the same class as the subordinating creditor should not receive the benefit of a subordination agreement to which they are not a party and on which they are not entitled to rely. They would receive a windfall benefit by the removal of the subordinating creditor from their class in the event that there were insufficient monies to fully pay their class because the total indebtedness of the class would be reduced and the pro rata distribution would be increased. Second, if the parties to the subordination agreement turned their minds to it, they would inevitably agree that the subordinating creditor should receive its normal share of the distribution and give it to the party in whose favour the subordination

  

was granted. The party receiving the subordination would agree because it would be paid a portion of a distribution to a higher class of creditor that it would not otherwise receive and the subordinating creditor would agree because it would not receive the money in either event.

**Conclusion**

40 In addition to the directions that I have already given, I direct the Trustee as follows:

1. To calculate the amounts for the distribution to the unsecured creditors on the basis that all of the parties who filed proofs of claim except the preferred creditors, and First Round Investors and the Second Round Investors are unsecured creditors of equal ranking;

2. To make the distribution to the unsecured creditors of their respective amounts except the sums that would be payable to T.K. Holdings Ltd. and Davis & Company in respect of the indebtedness for services rendered up to February 17, 1992 ($70,666 and $61,476.20);

3. To pay these excepted sums to or at the direction of the Second Round Investors if so directed by T.K. Holdings Ltd. or Davis & Company, as the case may be, and, if not so directed by either of T.K. Holdings Ltd. or Davis & Company, to retain the funds in interest bearing accounts pending further Order of this Court on application of T.K. Holdings Ltd., Davis & Company, the Trustee or any other interested party.

41 This direction is without prejudice to the rights of the Second Round Investors to pursue any of the creditors receiving a portion of the distribution on the basis that such creditor agreed with the Second Round Investors that its claim would be subordinated to their claims.

42 The Trustee was acting reasonably in bringing this application. Although I did not agree with the Trustee's proposed manner of distribution, I order that the parties shall bear their own costs and that, subject to normal taxation, the Trustee's costs may be paid from the bankruptcy estate.

*Order accordingly.*

Footnotes

1 *Laronge Realty Ltd. v. Golconda Investments Ltd.* (1986), 63 C.B.R. (N.S.) 76 (B.C. C.A.).

2 *Re Orzy* (1923), 3 C.B.R. 737 (Ont. C.A.) [at p. 741].

TAB 4

2000 ABQB 4
Alberta Court of Queen's Bench

Blue Range Resource Corp., Re

2000 CarswellAlta 12, 2000 ABQB 4, [2000] 4 W.W.R. 738, [2000] A.W.L.D. 183, [2000] A.J. No. 14, 15 C.B.R. (4th) 169, 259 A.R. 30, 76 Alta. L.R. (3d) 338, 94 A.C.W.S. (3d) 223

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

In the Matter of Blue Range Resource Corporation

Romaine J.

Judgment: January 10, 2000
Docket: Calgary 9901-04070

Counsel: *R.J. (Bob) Wilkins* and *Gary Befus*, for Big Bear Exploration Ltd.
*A. Robert Anderson* and *Bryan Duguid*, for Enron Trade & Capital Resources Canada Corp.
*Glen H. Poelman*, for Creditors' Committee.
*Virginia A. Engel*, for MRF 1998 II Limited Partnership.

Subject: Insolvency; Torts; Contracts; Corporate and Commercial; Civil Practice and Procedure

APPLICATION by creditors for direction with respect to respondent's claim.

***Romaine J.*:**

**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 Corp.* (*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 Corp.* 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 recently 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 *Matter of Stirling Homex Corp.*, 579 F.2d 206 (U.S. 2nd Cir. N.Y. 1978) 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 Corp.* 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: *Re Northwestern Trust Co.*, [1926] S.C.R. 412 (S.C.C.) at 419; *Milne v. Durham Hosiery Mills Ltd.*, [1925] 3 D.L.R. 725 (Ont. C.A.); *Trusts & Guarantee Co. v. Smith* (1923), 54 O.L.R. 144 (Ont. C.A.); *Re National Stadium Ltd.* (1924), 55 O.L.R. 199 (Ont. C.A.); *Oakes v. Turquand* (1867), [1861-73] All E.R. Rep. 738 (U.K. H.L.) at page 743-744.

38 The court in *Northwestern Trust Co. (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 (U.S. Va. 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 (U.S. C.C.A.8 Kan. 1896), 140:

> 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 *Re U.S. Financial Inc.*, 648 F.2d 515 (U.S. 9th Cir. Cal. 1980). 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 *Re THC Financial Corp.*, 679 F.2d 784 (U.S. 9th Cir. Hawaii 1982), 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 Corp.*, 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 & Co.* (1896), [1897] A.C. 22 (U.K. 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: *United States v. Noland*, 517 U.S. 535 (U.S. Ohio 1996); *Re Structurlite Plastics Corp.*, 193 B.R. 451 (U.S. Bankr. S.D. Ohio 1995). 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": *United States v. Noland (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 & York Developments Ltd. v. Royal Trust Co.* (1993), 17 C.B.R. (3d) 75 (Ont. Gen. Div. [Commercial List]) and *Unisource Canada Inc. v. Hongkong Bank of Canada* (1998), 43 B.L.R. (2d) 226 (Ont. Gen. Div.) 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.* (1989), 43 B.L.R. 67 (B.C. C.A.) 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.G. 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. v. Heller & Partners Ltd.* (1963), [1964] A.C. 465 (U.K. 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 <u>not if the statement had been true</u> 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* (1992), 11 C.B.R. (3d) 11 (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: *R. v. Wilson* (1983), 4 D.L.R. (4th) 577 (S.C.C.) 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.

*Order accordingly.*

TAB 5

2001 ABQB 583
Alberta Court of Queen's Bench

National Bank of Canada v. Merit Energy Ltd.

2001 CarswellAlta 913, 2001 ABQB 583, [2001] 10 W.W.R. 305, [2001] A.W.L.D. 539, [2001] A.J. No. 918, 107 A.C.W.S. (3d) 182, 28 C.B.R. (4th) 228, 294 A.R. 15, 95 Alta. L.R. (3d) 166

# 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.

LoVecchio J.

Heard: April 30, 2001
Judgment: July 3, 2001 *
Docket: Calgary 0001-04994, Bankruptcy No. 073154

Counsel: *Frank Dearlove*, *Chris Simard*, for Arthur Andersen Inc.
*William E. McNally*, *David A. Klein*, for Larry Delf, Representative Flow-Through Shareholder
*Jim G. Shea*, for Flow-Through Shareholders who are not members of the Representative Class
*Norman D. Anderson (Agent)*, for Magellan Aerospace Limited, Canada Dominion Resources Limited Partnership III
*Matthew R. Lindsay*, *Phil J. Schreiber*, for Underwriters except, First Energy Capital Corpration
*Tristram Mallet*, for First Energy Capital Corporation
*Douglas G. Stokes*, for certain Directors
*D. Detomasi*, for Barry Stobo
*Jeff Sharpe*, for Duncan Chisholm, Laurence Waller
*Graham McLennan*, for PriceWaterHouseCoopers LLP
*Steven H. Leitl*, for National Bank of Canada, Bank One, NA, Bank One Canada

Subject: Insolvency; Corporate and Commercial; Torts

APPLICATION by trustee for determination of status of exploration company's auditor, underwriters, directors, officers and shareholders as creditors of exploration company.

***LoVecchio J.*:**

## 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 *Blue Range Resource Corp., Re.* [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.

**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 *Blue Range Resource Corp., Re*.

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 *Canada Deposit Insurance Corp. 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 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, <u>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</u>. <u>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</u>. 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. <u>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</u>. 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. <u>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.</u> [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 *Blue Range Resource Corp., Re*, 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 *Blue Range Resource Corp., Re*, 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 *Blue Range Resource Corp., Re*, 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 *Central Capital Corp., Re* [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 *G.M.D. Vending Co., Re* [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 *Central Capital Corp., Re* 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 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 *Confederation Treasury Services Ltd., Re* [11] departed from the earlier cases relied upon by the Trustee, including *Claude Resources Inc. (Trustee of) v. Dutton* [12]. The Court of Appeal stated they imposed too high 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 *Blue Range Resource Corp., Re* 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 *Blue Range Resource Corp., Re* 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 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 *Blue Range Resource Corp., Re* 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 *Blue Range Resource Corp., Re*, 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 *Blue Range Resource Corp., Re*, 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.

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 *Central Capital Corp., Re* 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 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 *Blue Range Resource Corp., Re*. 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 *Blue Range Resource Corp., Re* 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, *Blue Range Resource Corp., Re* 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 *Blue Range Resource Corp., Re* 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 *Canada Deposit Insurance Corp. 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 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 Inc. (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 "<u>all</u> 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 *Confederation Treasury Services Ltd., Re* and held that the test of probable liability set out in *Claude Resources (Trustee of) v. Dutton* and *Wiebe, Re* (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 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 *Blue Range Resource Corp., Re*.

  

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 *Canada Deposit Insurance Corp. v. Canadian Commercial Bank* than to *Central Capital Corp., Re* 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.

*Order accordingly.*

Footnotes

* Affirmed 2002 ABCA 5, 2002 CarswellAlta 23 (Alta. C.A.).

1 Reasons followed the dismissal from the bench 2001 ABCA 138 (Alta. C.A.).

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.

5 (1992), 97 D.L.R. (4th) 385 (S.C.C.)

6 (1996), 27 O.R. (3d) 494 (Ont. 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 (Ont. Gen. Div. [Commercial List]), at 138-139.

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) 4 (Ont. C.A.).

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. Bktcy.) and followed in *Wiebe, Re* (1995), 30 C.B.R. (3d) 109 (Ont. Bktcy.)

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

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.

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

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.)

20 See for example, *Froment, Re*, [1925] 2 W.W.R. 415 (Alta. T.D.)