Court of Appeal File No. C56125
Superior Court File No. CV-12-9667-00CL

COURT OF APPEAL FOR ONTARIO

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

AND IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF SINO-FOREST CORPORATION

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

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Tab 1

CANADIAN SECURITIES REGULATION

FOURTH EDITION

DAVID JOHNSTON, C.C.
AND
KATHLEEN DOYLE ROCKWELL,
B.COMM., LL.B., LL.M.

WITH A FOREWORD BY
PURDY CRAWFORD
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CHAPTER 21 CONTRIBUTED BY
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B. General Requirements

1. Generally Accepted Accounting Principles ("GAAP")

Both annual and interim financial statements must be prepared according to GAAP and all provisions of the legislation, and audited according to Generally Accepted Auditing Standards ("GAAS").[43] GAAP is defined as the principles set out in NI 52-107, if used in reference to a statement to which NI 52-107 applies; otherwise, it is defined as the principles set out in the Handbook of the Canadian Institute of Chartered Accountants ("CICA").[44] GAAP covers many matters, including, for example, valuing inventory, depreciating capital assets and accounting for subsidiaries.

The Commission may accept deviations from GAAP. This is done by order (and published written reasons) after a hearing. The Commission must be satisfied that the reasons for variation outweigh the benefits of uniformity.[45] The Director may allow deviations from GAAP if it would be impractical to have the issuer revise the statement to conform to GAAP.[46]

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[43] NI 52-107 *Acceptable Accounting Principles, Auditing Standards and Reporting Currency*, ss. 3.1 and 3.2. OReg., s. 2(1); ARule, s. 144(1); BCRule, s. 3(3); and QSA, s. 80. Also see NI 81-106, ss. 2.6 and 2.7.

[44] For example, see OReg., s. 1(3). An "SEC issuer" may rely on U.S. GAAP and U.S. GAAS, if certain requirements are met — NI 52-107, ss. 4.1 and 4.2. A "foreign issuer", including an "SEC foreign issuer" may rely on U.S. GAAP or International Financial Reporting Standards and on U.S. GAAS or International Standards on Auditing, if certain requirements are met — NI 52-107, ss. 5.1 and 5.2. The provisions are similar for "foreign registrants" — NI 52-107, Part 8. International reforms appear to be moving towards simplification for issuers — see Chapter 18, International Issues and Development, 18.02 Internationalization, E. Barriers to Further Internationalization, 1. Accounting Standards. Using GAAP is a significant delegation of power to and reliance on a non-Commission authority — see 7.11 Criticisms and Calls for Reform of CD Requirements, E. Abdication of Regulatory Authority. One concern with using the CICA rules is that they are easily amended without the rigorous procedures and scrutiny that accompany changes to securities and corporate legislation. Therefore, issuers may not have the same notice or opportunity to comment on proposed changes. See Borden Ladner Gervais LLP, *Securities Law and Practice*, 3d ed. looseleaf (Toronto: Thomson, 2004) ("BLG") at para. 18.4.5.

[45] OReg., s. 2(4)(b); ARule, s. 144(4)(b); and BCRule, s. 3(8).

[46] OReg., s. 2(4)(a); ARule, s. 144(4)(a); and BCRule, ss. 3(7), (8). Some jurisdictions (for example, Alberta) also give the Director discretion where the Commission has previously issued an order accepting a statement with certain variations, and the circumstances have not materially changed, or if otherwise satisfied that it is not prejudicial to the public interest. Some issuers have increasingly used non-GAAP earnings and other financial measurements along with the required GAAP. Regulators are concerned with the potential to mislead investors (*i.e.*, by colouring financial statements in a too-favourable light) and have issued guidelines — see CSA Staff Notice 52-306 *Non-GAAP Financial Measures*.

2. *Auditor's Report*[47]

An auditor must comply with GAAS and give an auditor's report with no reservation (if warranted). The report must also set out details relating to any change of auditors and identify the auditing standard and the accounting principles used.[48]

Note that auditors are employed by the issuer, yet are seen by some (particularly by naïve investors) as having a public duty or a gatekeeper role. This is not reality; auditors do not guarantee an issuer's solvency or success. Their audits are to enable securityholders to oversee management, not to assist in personal investment decisions.[49]

3. *Significant or Material Information*

Financial statements need contain only significant matters.[50] However, the prospectus principle of full disclosure of all material facts equally applies to financial statements.[51]

Note that although a similar ground exists in Ontario for exercising discretion ("adequate justification"), another provision states that it is to be ignored — see OSA, s. 80(b)(iii) and ORule 51-801CP, s. 1.2. This latter point highlights a problem in the current regulatory environment, where legislative provisions are inoperative due to the implementation of national or multilateral instruments, but the legislatures have fallen behind on deleting the inoperative provisions. This is unacceptable, as it heightens confusion — therefore decreasing both efficiency and investor protection.

47 NI 51-102, Part 4; and NI 81-106, Part 2.

After auditors came under attack in the early 2000s, following several accounting-related scandals, the CSA, OSFI (Office of the Superintendent of Financial Institutions) and Canada's chartered accountants implemented a new system to oversee auditors — the Canadian Public Accountability Board (CPAB) (CSA, News Release, "New Independent Public Oversight for Auditors of Public Companies Announced by Federal and Provincial Regulators and Canada's Chartered Accountants" 17 July 2002). The CPAB is "to contribute to public confidence in the integrity of financial reporting of reporting issuers by promoting high quality, independent auditing." It also is responsible for an oversight program that inspects auditors — see <http://www.cpab-ccrc.ca> (visited 26 March 2006).

48 NI 52-107, s. 3.2.

49 See *Hercules Management Ltd. v. Ernst & Young*, [1997] S.C.J. No. 51, [1997] 2 S.C.R. 165 at para. 49. Also see A. Shapiro, "Who Pays the Auditor Calls the Tune?: Auditing Regulation and Clients' Incentives" (2005) 35 Seton Hall L. Rev. 1029.

50 *E.g.*, ARule, s. 144(7).

51 7.07 Material Change Reports ("MCRs"), B. Material Changes and Facts discusses materiality, the principles of which are also applicable to financial statement disclosure.

4. *Delivery of Financial Statements*

Reporting issuers must send registered holders and beneficial owners a form each year allowing those holders and owners to request copies of annual or interim financial statements, or both. Apart from the requirement to send the statements to those holders and owners who request them, there is no other financial statement delivery requirement.[52] The situation is slightly different for an investment fund, which must send out annual and interim statements to holders and owners, unless the investment fund has requested and received standing instructions from a holder or owner for another arrangement.[53]

C. Exemptions from the Financial Statement Requirements

The Commission may allow exemptions from the financial statement continuous disclosure requirements.[54] It is interesting that criteria and specifications (*e.g.*, public interest, a conflict or overlap with other legislation) are no longer explicitly set out. This appears to widen the Commission's discretion. In determining if adequate justification exists, the Commission will likely still perform the traditional cost/benefit balancing act.[55]

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[52] NI 51-102, s. 4.6. Also see NI 54-101 *Communication with Beneficial Owners of Securities of a Reporting Issuer*. 51-102CP, s. 10.1 states that any documents required to be sent under NI 51-102 may be sent electronically in accordance with NP 11-201 *Delivery of Documents by Electronic Means* (or Quebec Staff Notice, *The Delivery of Documents by Electronic Means*). Under proposed amendments to NI 51-102, issuers would no longer be required to send a request form to securityholders each year — CSA, *Notice of Request for Comment Proposed Amendments to NI 51-102 Continuous Disclosure Obligations, Form 51-102F1, Form 51-102F2, Form 51-102F3, Form 51-102F4, Form 51-102F5, Form 51-102F6 and Companion Policy 51-102CP Continuous Disclosure Obligations Proposed Amendments to NI 52-107 Acceptable Accounting Principles, Auditing Standards and Reporting Currency and Proposed Amendments to NI 71-102 Continuous Disclosure and Other Exemptions Relating to Foreign Issuers and Companion Policy 71-102CP Continuous Disclosure and Other Exemptions Relating to Foreign Issuers* (2005), 28 O.S.C.B. 9845. In addition, the delivery deadline for financial statements would be no later than 10 days after the filing deadline (at 9847).

[53] NI 81-106, Part 5; and NI 54-101.

[54] NI 52-107, Part 9.

[55] For example, in *Re Lakewood Energy Inc.* (1992), 15 O.S.C.B. 3133, the OSC allowed the issuer to release its interim financial statements later than the statutory deadline, as it needed more time to incorporate a recent transaction. For further discussion of the principles and factors considered in the balancing act, see, *e.g.*, OSC Notice 52-716 *Filing Extensions for Continuous Disclosure Financial Statement* (2003), 26 O.S.C.B. 2317, although this is slated to be withdrawn — see Policy Reformulation Table of Concordance and List of New Instruments

Tab 2

Indexed as:

Hercules Managements Ltd. v. Ernst & Young

Hercules Managements Ltd., Guardian Finance of Canada Ltd. and Max Freed, appellants (plaintiffs/respondents), and Friendly Family Farms Ltd., Woodvale Enterprises Ltd., Arlington Management Consultants Ltd., Emarjay Holdings Ltd. and David Korn, (plaintiffs);

v.

Ernst & Young and Alexander Cox, respondents (defendants/applicants), and Max Freed, David Korn and Marshall Freed, (third parties), and The Canadian Institute of Chartered Accountants, intervener.

[1997] 2 S.C.R. 165

[1997] S.C.J. No. 51

File No.: 24882.

Supreme Court of Canada

1996: December 6 / 1997: May 22.

Present: La Forest, Sopinka, Gonthier, Cory, McLachlin, Iacobucci and Major JJ.

ON APPEAL FROM THE COURT OF APPEAL FOR MANITOBA

Negligence -- Negligent misrepresentation -- Auditors' report prepared for company -- Report required by statute -- Individual investors alleging investment losses and losses in value of existing shareholdings incurred because of reliance on audit reports -- Whether auditors owed individual investors a duty of care with respect to the investment losses and the losses in the value of existing shareholdings -- Whether the rule in Foss v. Harbottle affects the appellants' action.

Northguard Acceptance Ltd. ("NGA") and Northguard Holdings Ltd. ("NGH") carried on business lending and investing money on the security of real property mortgages. The appellant Guardian Finance of Canada Ltd. ("Guardian") was the sole shareholder of NGH and it held non-voting class B shares in NGA. The appellants Hercules Managements Ltd. ("Hercules") and Max Freed were

also shareholders in NGA. At all relevant times, ownership in the corporations was separated from management. The respondent Ernst & Young was originally hired by NGA and NGH in 1971 to perform annual audits of their financial statements and to provide audit reports to the companies' shareholders. The partner in charge of the audits for the years 1980 and 1981, Cox, held personal investments in some of the syndicated mortgages administered by NGA and NGH.

In 1984, both NGA and NGH went into receivership. The appellants, and a number of other shareholders or investors in NGA, brought an action against the respondents in 1988 alleging that the audit reports for the years 1980, 1981 and 1982 were negligently prepared and that in reliance on these reports, they suffered various financial losses. They also alleged that a contract existed between themselves and the respondents in which the respondents explicitly undertook to protect the shareholders' individual interests in the audits as distinct from the interests of the corporations themselves.

The respondents brought a motion for summary judgment in the Manitoba Court of Queen's Bench seeking to have the plaintiffs' claims dismissed. The grounds for the motion were (a) that there was no contract between the plaintiffs and the respondents; (b) that the respondents did not owe the individual plaintiffs any duty of care in tort; and (c) that the claims asserted by the plaintiffs could only properly be brought by the corporations themselves and not by the shareholders individually. The motions judge granted the motion with respect to four plaintiffs, including the appellants, and dismissed their actions on the basis that they raised no genuine issues for trial. By agreement, the claims of the remaining plaintiffs were adjourned sine die. An appeal to the Manitoba Court of Appeal was unanimously dismissed with costs.

At issue here are: (1) whether the respondents owe the appellants a duty of care with respect to (a) the investment losses they incurred allegedly as a result of reliance on the 1980-82 audit reports, and (b) the losses in the value of their existing shareholdings they incurred allegedly as a result of reliance on the 1980-82 audit reports; and (2) whether the rule in Foss v. Harbottle (which provides that individual shareholders have no cause of action in law for any wrongs done to the corporation) affects the appellants' action.

Held: The appeal should be dismissed.

Four preliminary matters were addressed before the principal issue. Firstly, the question to be decided on a motion for summary judgment under rule 20 of the Manitoba Court of Queen's Bench Rules is whether there is a genuine issue for trial. Although a defendant who seeks dismissal of an action has an initial burden of showing that the case is one in which the existence of a genuine issue is a proper question for consideration, it is the plaintiff who must then, according to the rule, establish his claim as being one with a real chance of success. Thus, the appellants (who were the plaintiffs-respondents on the motion) bore the burden of establishing that their claim had "a real chance of success". Secondly, no contract existed between the appellant shareholders and the respondents and, in any event, the contract claim was not properly before this Court. Consequently, the appellants' submissions in this regard must fail. Thirdly, the independence requirements set out in s. 155 of the Manitoba Corporations Act do not themselves give rise to a cause of action in negligence. Similarly, breach of those independence requirements could not establish a duty of care in tort. Finally, it was not necessary to inquire into whether the appellants actually relied on the audited re-

ports prepared by the respondents because the finding of an absence of a duty of care rendered the question of actual reliance inconsequential.

The existence of a duty of care in tort is to be determined through an application of the two-part Anns/Kamloops test (Anns v. Merton London Borough Council; Kamloops (City of) v. Nielsen). That approach should be taken here. To create a "pocket" of negligent misrepresentation cases in which the existence of a duty of care is determined differently from other negligence cases would be incorrect. Whether the respondents owe the appellants a duty of care for their allegedly negligent preparation of the audit reports, therefore, depends on (a) whether a prima facie duty of care is owed, and (b) whether that duty, if it exists, is negated or limited by policy considerations.

The existence of a relationship of "neighbourhood" or "proximity" distinguishes those circumstances in which the defendant owes a prima facie duty of care to the plaintiff from those where no such duty exists. In the context of a negligent misrepresentation action, deciding whether a prima facie duty of care exists necessitates an investigation into whether the defendant-representor and the plaintiff-representee can be said to be in a relationship of proximity or neighbourhood. The term "proximity" itself is nothing more than a label expressing a result, judgment or conclusion and does not, in and of itself, provide a principled basis on which to make a legal determination.

"Proximity" in negligent misrepresentation cases pertains to some aspect of the relationship of reliance. It inheres when (a) the defendant ought reasonably to foresee that the plaintiff will rely on his or her representation, and (b) reliance by the plaintiff would, in the particular circumstances of the case, be reasonable.

Looking to whether reliance by the plaintiff would be reasonable in determining whether a prima facie duty of care exists (as opposed to looking at reasonable foreseeability alone) is not to abandon the basic tenets underlying the first branch of the Anns/Kamloops test. While specific inquiries into the reasonableness of the plaintiff's expectations are not normally required in the context of physical damage cases (since the law has come to recognize implicitly that plaintiffs are reasonable in expecting that defendants will take reasonable care of their persons and property), such an inquiry is necessary in the negligent misrepresentation context. This is because reliance by a plaintiff on a defendant's representation will not always be reasonable. Only by inquiring into the reasonableness of the plaintiff's reliance will the Anns/Kamloops test be applied consistently in both contexts.

The reasonable foreseeability/reasonable reliance test for determining a prima facie duty of care is somewhat broader than the tests used both in the cases decided before Anns and in those that have rejected the Anns approach. Those cases typically require (a) that the defendant know the identity of either the plaintiff or the class of plaintiffs who will rely on the statement, and (b) that the reliance losses claimed by the plaintiff stem from the particular transaction in respect of which the statement at issue was made. In reality, inquiring into such matters is nothing more than a means by which to circumscribe -- for reasons of policy -- the scope of a representor's potentially infinite liability. In other words, adding further requirements to the duty of care test provides a means by which concerns that are extrinsic to simple justice -- but that are, nevertheless, fundamentally important -- may be taken into account in assessing whether the defendant should be compelled to compensate the plaintiff for losses suffered.

In light of this Court's endorsement of the Anns/Kamloops test, enquiries concerning (a) the defendant's knowledge of the identity of the plaintiff (or of the class of plaintiffs) and (b) the use to which the statements at issue are put may now quite properly be conducted in the second branch of that

test when deciding whether policy considerations ought to negate or limit a prima facie duty that has already been found to exist. Criteria that in other cases have been used to define the legal test for the duty of care can now be recognized as policy-based ways by which to curtail liability and they can appropriately be considered under the policy branch of the Anns/Kamloops test.

The fundamental policy consideration that must be addressed in negligent misrepresentation actions centres around the possibility that the defendant might be exposed to "liability in an indeterminate amount for an indeterminate time to an indeterminate class". While the criteria of reasonable foreseeability and reasonable reliance serve to distinguish cases where a prima facie duty is owed from those where it is not, these criteria can, in certain types of situations, quite easily be satisfied and, absent some means by which to circumscribe the ambit of the duty, the prospect of limitless liability will loom. The general area of auditors' liability is a case in point. Here, the problem of indeterminate liability will often arise because the reasonable foreseeability/reasonable reliance test for ascertaining a prima facie duty of care may be satisfied in many, even if not all, such cases.

While policy concerns surrounding indeterminate liability will serve to negate a prima facie duty of care in many auditors' negligence cases, there may be particular situations where such concerns do not inhere. The specific factual matrix of a given case may render it an "exception" to the general class of cases, in that while considerations of proximity might militate in favour of finding that a duty of care inheres, the typical policy considerations stemming from indeterminate liability do not arise.

This concept can be articulated within the framework of the Anns/Kamloops test. Under this test, factors such as (1) whether the defendant knew the identity of the plaintiff (or the class of plaintiff) and (2) whether the defendant's statements were used for the specific purpose or transaction for which they were made ought properly to be considered in the "policy" branch of the test once the first branch concerning "proximity" has been found to be satisfied. The absence of these factors will normally mean that concerns over indeterminate liability inhere and, therefore, that the prima facie duty of care will be negated. Their presence, however, will mean that worries stemming from indeterminacy should not arise since the scope of liability is sufficiently delimited. In such cases, policy considerations will not override a positive finding on the first branch of the Anns/Kamloops test and a duty of care will quite properly be found to exist.

On the facts of this case, the respondents clearly owed a prima facie duty of care to the appellants. Firstly, the possibility that the appellants would rely on the audited financial statements in conducting their affairs and that they might suffer harm if the reports were negligently prepared must have been reasonably foreseeable to the respondents. Secondly, reliance on the audited statements by the appellant shareholders would, on the facts, be reasonable given both the relationship between the parties and the nature of the statements themselves. The first branch of the Anns/Kamloops test is therefore satisfied.

As regards the second branch of this test, it is clear that the respondents knew the identity of the appellants when they provided the audit reports. In determining whether this case is an "exception" to the generally prevailing policy concerns regarding auditors, the central question is therefore whether the appellants can be said to have used the audit reports for the specific purpose for which they were prepared. The answer will determine whether policy considerations surrounding indeterminate liability ought to negate the prima facie duty of care owed by the respondents.

The respondent auditors' purpose in preparing the reports was to assist the collectivity of shareholders of the audited companies in their task of overseeing management. The respondents did not prepare the audit reports in order to assist the appellants in making personal investment decisions or, indeed, for any purpose other than the standard statutory one. The only purpose for which the reports could have been used so as to give rise to a duty of care on the part of the respondents, therefore, is as a guide for the shareholders, as a group, in supervising or overseeing management.

In light of this finding, the specific claims of the appellants could each be assessed. Those claims were in respect of: (1) moneys injected into NGA and NGH by Hercules and Freed, and (2) the devaluation of existing equity caused by the appellants' alleged inability (a) to oversee personal investments properly, and (b) to supervise the management of the corporations with a view to protecting their personal holdings.

As regards the first claim, the appellants alleged that they relied on the respondents' audit reports for the purpose of making individual investments. Since this was not a purpose for which the reports were prepared, policy concerns surrounding indeterminate liability are not obviated and these claims must fail. Similarly, the first branch of the appellants' second claim must fail since monitoring existing personal investments is likewise not a purpose for which the audited statements were prepared.

With respect to the second branch relating to the devaluation of appellants' equity, the appellants' position may at first seem consistent with the purpose for which the reports were prepared. In reality, however, their claim did not involve the purpose of overseeing management per se. Rather, it ultimately depended on being able to use the auditors' reports for the individual purpose of overseeing their own investments. Thus, the purpose for which the reports were used was not, in fact, consistent with the purpose for which they were prepared. The policy concerns surrounding indeterminate liability accordingly inhered and the prima facie duty of care was negated in respect of this claim as well.

The absence of a duty of care with respect to the appellant's alleged inability to supervise management in order to monitor their individual investments is consistent with the rule in Foss v. Harbottle which provides that individual shareholders have no cause of action for wrongs done to the corporation. When, as a collectivity, shareholders oversee the activities of a corporation through resolutions adopted at shareholder meetings, they assume what may be seen to be a "managerial" role. In this capacity, they cannot properly be understood to be acting simply as individual holders of equity. Rather, their collective decisions are made in respect of the corporation itself. Any duty owed by auditors in respect of this aspect of the shareholders' functions is owed not to shareholders qua individuals, but rather to all shareholders as a group, acting in the interests of the corporation. Since the decisions taken by the collectivity of shareholders are in respect of the corporation's affairs, the shareholders' reliance on negligently prepared audit reports in taking such decisions will result in a wrong to the corporation for which the shareholders cannot, as individuals, recover. A derivative action would have been the proper method of proceeding with respect to this claim.

Cases Cited

Considered: Fidkalo v. Levin (1992), 76 Man. R. (2d) 267; Caparo Industries plc. v. Dickman, [1990] 1 All E.R. 568; Anns v. Merton London Borough Council, [1978] A.C. 728; Kamloops (City of) v. Nielsen, [1984] 2 S.C.R. 2; Canadian National Railway Co. v. Norsk Pacific Steamship Co., [1992] 1 S.C.R. 1021; Hedley Byrne & Co. v. Heller & Partners Ltd., [1964] A.C. 465; Haig v.

Bamford, [1977] 1 S.C.R. 466; Ultramares Corp. v. Touche, 174 N.E. 441 (1931); Glanzer v. Shepard, 135 N.E. 275 (1922); referred to: Foss v. Harbottle (1843), 2 Hare 460, 67 E.R. 189; Hercules Management Ltd. v. Clarkson Gordon (1994), 91 Man. R. (2d) 216; R. in right of Canada v. Saskatchewan Wheat Pool, [1983] 1 S.C.R. 205; Queen v. Cognos Inc., [1993] 1 S.C.R. 87; Murphy v. Brentwood District Council, [1991] 1 A.C. 398; Sutherland Shire Council v. Heyman (1985), 60 A.L.R. 1; B.D.C. Ltd. v. Hofstrand Farms Ltd., [1986] 1 S.C.R. 228; London Drugs Ltd. v. Kuehne & Nagel International Ltd., [1992] 3 S.C.R. 299; Winnipeg Condominium Corporation No. 36 v. Bird Construction Co., [1995] 1 S.C.R. 85; Edgeworth Construction Ltd. v. N. D. Lea & Associates Ltd., [1993] 3 S.C.R. 206; Scott Group Ltd. v. McFarlane, [1978] 1 N.Z.L.R. 553; Donoghue v. Stevenson, [1932] A.C. 562; Candler v. Crane, Christmas & Co., [1951] 2 K.B. 164; H. Rosenblum (1983), Inc. v. Adler, 461 A.2d 138 (1983); Roman Corp. Ltd. v. Peat Marwick Thorne (1992), 11 O.R. (3d) 248; Roman Corp. v. Peat Marwick Thorne (1993), 12 B.L.R. (2d) 10; Prudential Assurance Co. v. Newman Industries Ltd. (No. 2), [1982] 1 All E.R. 354; Goldex Mines Ltd. v. Revill (1974), 7 O.R. (2d) 216.

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Corporations Act, R.S.M. 1987, c. C225, ss. 149(1), 155(1), (2), (6), 163(1), 232.
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APPEAL from a judgment of the Manitoba Court of Appeal (1995), 102 Man. R. (2d) 241, 93 W.A.C. 241, 125 D.L.R. (4th) 353, 19 B.L.R. (2d) 137, 24 C.C.L.T. (2d) 284, dismissing an appeal from judgment by Dureault J. Appeal dismissed.

Mark M. Schulman, Q.C., and Brian A. Crane, Q.C., for the appellants.

Robert P. Armstrong, Q.C., and Thor J. Hansell, for the respondents.
W. Ian C. Binnie, Q.C., and Geoff R. Hall, for the intervener.

Solicitors for the appellants: Schulman & Schulman, Winnipeg.
Solicitors for the respondents: Aikins, MacAulay, Thorvaldson, Winnipeg.
Solicitors for the intervener: McCarthy, Tétrault, Toronto.

The judgment of the Court was delivered by

1 **LA FOREST J.**:-- This appeal arises by way of motion for summary judgment. It concerns the issue of whether and when accountants who perform an audit of a corporation's financial statements owe a duty of care in tort to shareholders of the corporation who claim to have suffered losses in reliance on the audited statements. It also raises the question of whether certain types of claims against auditors may properly be brought by shareholders as individuals or whether they must be brought by the corporation in the form of a derivative action.

Facts

2 Northguard Acceptance Ltd. ("NGA") and Northguard Holdings Ltd. ("NGH") carried on business lending and investing money on the security of real property mortgages. The appellant Guardian Finance of Canada Ltd. ("Guardian") was the sole shareholder of NGH and it held non-voting class B shares in NGA. The appellants Hercules Managements Ltd. ("Hercules") and Max Freed were also shareholders in NGA. At all relevant times, ownership in the corporations was separated from management. The respondent Ernst & Young (formerly known as Clarkson Gordon) is a firm of chartered accountants that was originally hired by NGA and NGH in 1971 to perform annual audits of their financial statements and to provide audit reports to the companies' shareholders. The partner in charge of the audits for the years 1980 and 1981 is the respondent William Alexander Cox. Mr. Cox held personal investments in some of the syndicated mortgages administered by NGA and NGH.

3 In 1984, both NGA and NGH went into receivership. The appellants, as well as Friendly Family Farms Ltd. ("F.F. Farms"), Woodvale Enterprises Ltd. ("Woodvale"), Arlington Management Consultants Ltd. ("Arlington"), Emarjay Holdings Ltd. ("Emarjay") and David Korn (all of whom were shareholders or investors in NGA) brought an action against the respondents in 1988 alleging that the audit reports for the years 1980, 1981 and 1982 were negligently prepared and that in reliance on these reports, they suffered various financial losses. More specifically, the appellant Hercules sought damages for advances totalling $600,000 which it made to NGA in January and February of 1983, and the appellant Freed sought damages for monies he added to an investment account in NGH in 1982. All the plaintiffs claimed damages in tort for the losses they suffered in the value of their existing shareholdings. In addition to their tort claims, the plaintiffs also alleged that a contract existed between themselves and the respondents in which the respondents explicitly undertook, as of 1978, to protect the shareholders' individual interests in the audits as distinct from the interests of the corporations themselves.

4 After a series of amendments to the initial statement of claim, over 40 days of discovery, and numerous pre-trial conferences and case management sessions, the respondents brought a motion

for summary judgment in the Manitoba Court of Queen's Bench seeking to have the plaintiffs' claims dismissed. The grounds for the motion were (a) that there was no contract between the plaintiffs and the respondents; (b) that the respondents did not owe the individual plaintiffs any duty of care in tort; and (c) that the claims asserted by the plaintiffs could only properly be brought by the corporations themselves and not by the shareholders individually. The motions judge granted the motion with respect to the plaintiffs Hercules, F.F. Farms, Woodvale, Guardian and Freed and dismissed their actions on the basis that they raised no genuine issues for trial. By agreement, the claims of the remaining plaintiffs were adjourned sine die. An appeal to the Manitoba Court of Appeal by Hercules, Guardian and Freed was unanimously dismissed with costs. Leave to appeal to this Court was granted on March 7, 1996 and the appeal was heard on December 6, 1996.

Judicial History

Manitoba Court of Queen's Bench

5 Dureault J. began his reasons by noting that only the claims of Hercules, F.F. Farms, Woodvale, Guardian and Freed had to be addressed since, by agreement, the claims of the other plaintiffs had been adjourned. He then proceeded to set out the appropriate test to be applied in summary judgment motions. Referring to Rule 20.03(1) of the Manitoba Court of Queen's Bench Rules, Reg. 553/88, (which governs summary judgment motions) and citing Fidkalo v. Levin (1992), 76 Man. R. (2d) 267 (C.A.), he explained that while the defendant bears the initial burden of proving that the case is one where the question whether there exists a genuine issue for trial can properly be raised, the plaintiff bears the subsequent burden of establishing that his claim has a real chance of success.

6 After rejecting the claim of the plaintiff F.F. Farms on the ground that it failed from the outset to establish any cause of action, Dureault J. turned to the more substantive issues in the motion. He began by addressing the question whether the plaintiffs qua shareholders may properly bring an action for the devaluation in their shareholdings in NGA and NGH, and held that

> . . . shareholders have no cause of action in law for any wrongs which may have been inflicted upon a corporation. This principle of law is often referred to as "the rule in Foss v. Harbottle". The plaintiff shareholders are trying to get around this principle. At best, if any wrong was done in the conduct of the defendants' audits, it was done to [NGA] and [NGH] and cannot be considered an injury sustained by the shareholders.

Dureault J. found on this basis that the claims of Hercules, Guardian, Woodvale and Freed did not disclose any genuine issue for trial since they ought to have been brought by the corporations and not by the plaintiffs as individual shareholders.

7 The motions judge next addressed the question whether any duty of care in tort was owed by the defendants to the plaintiffs in their capacities as either shareholders or investors in the audited corporations. He noted that

> [g]enerally speaking, the law requires more than foreseeability and reliance. Actual knowledge on the part of the accountant/auditor of the limited class that will use and rely on the statements, referred to as the "proximity test", is also required.

Adopting the defendants' submissions on this issue, Dureault J. found that no duty of care was owed the plaintiffs because the audited statements were not prepared specifically for the purpose of assisting them in making investment decisions.

8 Finally, Dureault J. addressed the plaintiffs' claim that their losses stemmed from a breach of contract by the defendants. He recognized that the engagement of the auditors by the corporations is a contractual relationship, but rejected the contention that this relationship can be extended to include the shareholders so as to permit them to bring personal actions against the auditors in the event of breach. Finding that none of the plaintiffs' claims raised a genuine issue for trial, Dureault J. granted the motion with costs.

Manitoba Court of Appeal (1995), 102 Man. R. (2d) 241 (Philp, Lyon and Helper JJ.A.)

9 An appeal was brought to the Manitoba Court of Appeal by Hercules, Guardian and Freed. Helper J.A., writing for the court, began her reasons by finding that the learned motions judge had correctly applied the Fidkalo test for summary judgment motion under Rule 20.03(1) She also distinguished that test from that applicable on a motion to strike pleadings on the ground that, unlike the situation on a motion to strike, a Rule 20 motion requires an examination of the evidence in support of the plaintiff's claim.

10 Turning to the question whether the respondents owed a duty of care in tort to the appellants, Helper J.A. noted the latter's two alternative submissions. The first (at p. 244) was that

> . . . a common law duty of care arose . . . because the respondents knew or ought to have known: i) that the appellants were relying on the audited statements and the services and advice provided by the respondents; ii) the purpose for which the appellants would rely upon the respondents' services and statements; iii) that the appellants did so rely upon those audited statements for investment and other purposes; and iv) that the respondents breached their duties to the appellants thereby causing them a financial loss.

In response to this claim, Helper J.A. explained, the respondents contended that the appellants were simply trying to avoid the rule in Foss v. Harbottle (1843), 2 Hare 460, 67 E.R. 189 (H.L.), by asserting their claims as individual shareholders rather than by way of derivative action. The respondents also argued that they had no knowledge that investments would be made on the basis of the audited statements and that there was no evidence to support the contention that they ought to have known that their reports would be relied upon in this manner. Finally, Helper J.A. noted, the respondents asserted that there was no evidence demonstrating that the appellants had, in fact, relied on the audited statements at issue.

11 In analysing this first main submission, Helper J.A. undertook a thorough review of Caparo Industries plc. v. Dickman, [1990] 1 All E.R. 568, where the House of Lords considered the question of the scope of the duty of care owed by auditors to shareholders and investors. After reviewing the Canadian case law on the matter, she concluded, at p. 248, that

> [t]he appellants were unable to direct this court to any evidence in support of their position which was ignored by the motions judge. Nor am I persuaded that the order dismissing the appellants' claims is contrary to the existing jurisprudence.

> The evidence showed that the auditors had prepared the annual reports to comply with their statutory obligations. There was a total absence of evidence to indicate the respondents knew the appellants would rely upon the reports for any specific purpose or that the appellants did rely upon the reports before infusing more capital into their companies. The appellants were content to allow management to continue running the companies despite a drop in profitability reflected in the 1982 audited report and invested more capital in the face of that report. The evidence filed in opposition to the motion did not support the appellants' claim on this issue.

In the view of the Manitoba Court of Appeal, then, the first of the appellants' submissions regarding the existence of a duty of care could not succeed.

12 The appellants' second main submission concerning the existence of a duty of care consisted in an allegation that the respondent auditors contravened the statutory independence requirements set out in s. 155 of the Manitoba Corporations Act, R.S.M. 1987, c. C225, and that this in itself gave rise to a cause of action in the individual shareholders. The relevant portions of s. 155 are as follows:

> 155(1) Subject to subsection (5), a person is disqualified from being an auditor of a corporation if he is not independent of the corporation, all of its affiliates, and the directors or officers of the corporation and its affiliates.
>
> 155(2) For the purposes of this section,
>
> (a) independence is a question of fact; and
>
> (b) a person is deemed not to be independent if he or his business partner
>
> (i) is a business partner, a director, an officer or an employee of the corporation or any of its affiliates, or a business partner of any director, officer or employee of the corporation or any of its affiliates, or
>
> (ii) beneficially owns or controls, directly or indirectly, a material interest in the securities of the corporation or any of its affiliates, or
>
> (iii) has been a receiver, receiver-manager, liquidator or trustee in bankruptcy of the corporation or any of its affiliates within two years of his proposed appointment as auditor of the corporation.
>
> . . .
>
> 155(6) The shareholders of a corporation may resolve to appoint as auditor, a person otherwise disqualified under subsections (1) and (2) if the resolution is consented to by all the shareholders including shareholders not otherwise entitled to vote.

Specifically, the appellants alleged that because s. 155(6) of the Act allows a single shareholder to exercise a veto power over the appointment of the auditors, each shareholder also has a right of action against the auditors where damage has been occasioned by a breach of the independence requirement in s. 155(2). Helper J.A. rejected this submission both on the ground that it was unsupported by authority and on the basis that the wording of s. 155 as a whole does not suggest the interpretation urged by the appellants.

13 Finally, Helper J.A. addressed the appellants' contractual claim and held that the respondents' engagement to audit the financial statements of NGA and NGH in accordance with the Act did not give rise to a contractual relationship between them and the appellants. Similarly, she found the appellants could not sue on the contract between the corporations and the respondent Ernst & Young because of the lack of privity. Finding no evidence to support the existence of the requisite contractual relationship, Helper J.A. rejected the appellants' claim in this regard. For all these reasons, the Court of Appeal unanimously dismissed the appeal with costs.

Issues

14 The issues in this case may be stated as follows:

(1) Do the respondents owe the appellants a duty of care with respect to

(a) the investment losses they incurred allegedly as a result of reliance on the 1980-82 audit reports; and
(b) the losses in the value of their existing shareholdings they incurred allegedly as a result of reliance on the 1980-82 audit reports?

(2) Does the rule in Foss v. Harbottle affect the appellants' action?

Analysis

Preliminary Matters

15 Four preliminary matters should be addressed before turning to the principal issues in this appeal. The first concerns the procedure to be followed in a motion for summary judgment brought under Rule 20.03(1) of the Manitoba Court of Queen's Bench Rules. That rule provides as follows:

> 20.03(1) Where the court is satisfied that there is no genuine issue for trial with respect to a claim or defence, the court shall grant summary judgment accordingly.

I would agree with both the Court of Appeal and the motions judge in their endorsement of the procedure set out in Fidkalo, supra, at p. 267, namely:

> The question to be decided on a rule 20 motion is whether there is a genuine issue for trial. Although a defendant who seeks dismissal of an action has an initial burden of showing that the case is one in which the existence of a genuine issue is a proper question for consideration, it is the plaintiff who must then, according to the rule, establish his claim as being one with a real chance of success.

In the instant case, then, the appellants (who were the plaintiffs-respondents on the motion) bore the burden of establishing that their claim had "a real chance of success". They bear the same burden in this Court.

16 The second preliminary matter concerns the appellants' claim that as a result of a meeting in the summer of 1978 between David Korn, Max Freed and the respondent Cox and in light of an engagement letter sent by the respondents to NGA and NGH in 1981, a contract was formed between the shareholders of the audited corporations, on the one hand, and the respondents, on the other. This purported contract ostensibly required the respondents to conduct their audits for the benefit of the shareholders themselves and not merely for the benefit of the corporations. I have reviewed the portions of the record upon which the appellants base this submission and I am unable to find that the requisite elements of contract formation inhere on the facts. In any event, as the respondents pointed out, the appellants' request to amend their pleadings before trial to include a claim for breach of contract was denied by Kennedy J. and no appeal was brought from that decision. (See: Hercules Management Ltd. v. Clarkson Gordon (1994), 91 Man. R. (2d) 216 (Q.B.).) I would find, therefore, that the claim in breach of contract is not properly before this Court and that the appellants' submissions in this regard must fail.

17 Thirdly, the appellants allege that the respondent Cox's investments in certain syndicated mortgages administered by NGA and NGH constituted a breach of the statutory independence requirements set out in s. 155 of the Manitoba Corporations Act and that such a breach either gives rise to a private law cause of action or, alternatively, that it provides an independent basis for finding a duty of care in a tort action. Assuming without deciding that the respondent Cox was in breach of the independence requirements set out in that section, I would agree with Helper J.A. in finding that the section does not, in and of itself, give rise to a cause of action in negligence; see: R. in right of Canada v. Saskatchewan Wheat Pool, [1983] 1 S.C.R. 205. Similarly, I cannot see how breach of the independence requirements could establish a duty of care in tort. This does not mean, of course, that the statutory audit requirements set out in the Manitoba Corporations Act are entirely irrelevant to the appellants' claim. Rather, it simply means that a breach of the independence provisions does not, by itself, give rise either to an independent right of action or to a duty of care.

18 The final preliminary matter concerns whether or not the appellants actually relied on the 1980-82 audited reports prepared by the respondents. More specifically, the appellants allege that the Court of Appeal erred in finding, at p. 248, that

> [t]here was a total absence of evidence to indicate the respondents knew the appellants would rely upon the reports for any specific purpose or that the appellants did rely upon the [1980-82] reports before infusing more capital into their companies. The appellants were content to allow management to continue running the companies despite a drop in profitability reflected in the 1982 audited report and invested capital in the face of that report. The evidence filed in opposition to the motion did not support the appellants' claim on this issue. [Emphasis added.]

Needless to say, actual reliance is a necessary element of an action in negligent misrepresentation and its absence will mean that the plaintiff cannot succeed in holding the defendant liable for his or her losses; see: Queen v. Cognos Inc., [1993] 1 S.C.R. 87, at p. 110. In light of my disposition on the duty of care issue, however, it is unnecessary to inquire into this matter here -- the absence of a

duty of care renders inconsequential the question of actual reliance. Having dealt with all four preliminary matters, then, I can now turn to a discussion of the principal issues in this appeal.

Issue 1: Whether the Respondents owe the Appellants a Duty of Care

(i) Introduction

19 It is now well established in Canadian law that the existence of a duty of care in tort is to be determined through an application of the two-part test first enunciated by Lord Wilberforce in Anns v. Merton London Borough Council, [1978] A.C. 728 (H.L.), at pp. 751-52:

> First one has to ask whether, as between the alleged wrongdoer and the person who has suffered damage there is a sufficient relationship of proximity or neighbourhood such that, in the reasonable contemplation of the former, carelessness on his part may be likely to cause damage to the latter -- in which case a prima facie duty of care arises. Secondly, if the first question is answered affirmatively, it is necessary to consider whether there are any considerations which ought to negative, or to reduce or limit the scope of the duty or the class of person to whom it is owed or the damages to which a breach of it may give rise. . . .

While the House of Lords rejected the Anns test in Murphy v. Brentwood District Council, [1991] 1 A.C. 398, and in Caparo, supra, at p. 574, per Lord Bridge and at pp. 585-86, per Lord Oliver (citing Brennan J. in Sutherland Shire Council v. Heyman (1985), 60 A.L.R. 1 (H.C.), at pp. 43-44), the basic approach that test embodies has repeatedly been accepted and endorsed by this Court. (See, e.g.: Kamloops (City of) v. Nielsen, [1984] 2 S.C.R. 2; B.D.C. Ltd. v. Hofstrand Farms Ltd., [1986] 1 S.C.R. 228; Canadian National Railway Co. v. Norsk Pacific Steamship Co., [1992] 1 S.C.R. 1021; London Drugs Ltd. v. Kuehne & Nagel International Ltd., [1992] 3 S.C.R. 299; Winnipeg Condominium Corporation No. 36 v. Bird Construction Co., [1995] 1 S.C.R. 85.)

20 In Kamloops, supra, at pp. 10-11, Wilson J. restated Lord Wilberforce's test in the following terms:

> (1) is there a sufficiently close relationship between the parties (the [defendant] and the person who has suffered the damage) so that, in the reasonable contemplation of the [defendant], carelessness on its part might cause damage to that person? If so,
> (2) are there any considerations which ought to negative or limit (a) the scope of the duty and (b) the class of persons to whom it is owed or (c) the damages to which a breach of it may give rise?

As will be clear from the cases earlier cited, this two-stage approach has been applied by this Court in the context of various types of negligence actions, including actions involving claims for different forms of economic loss. Indeed, it was implicitly endorsed in the context of an action in negligent misrepresentation in Edgeworth Construction Ltd. v. N. D. Lea & Associates Ltd., [1993] 3 S.C.R. 206, at pp. 218-19. The same approach to defining duties of care in negligent misrepresentation cases has also been taken in other Commonwealth courts. In Scott Group Ltd. v. McFarlane, [1978] 1 N.Z.L.R. 553, for example, a case that dealt specifically with auditors' liability for negli-

gently prepared audit reports, the Anns test was adopted and applied by a majority of the New Zealand Court of Appeal.

21 I see no reason in principle why the same approach should not be taken in the present case. Indeed, to create a "pocket" of negligent misrepresentation cases (to use Professor Stapleton's term) in which the existence of a duty of care is determined differently from other negligence cases would, in my view, be incorrect; see: Jane Stapleton, "Duty of Care and Economic Loss: a Wider Agenda" (1991), 107 L.Q. Rev. 249. This is not to say, of course, that negligent misrepresentation cases do not involve special considerations stemming from the fact that recovery is allowed for pure economic loss as opposed to physical damage. Rather, it is simply to posit that the same general framework ought to be used in approaching the duty of care question in both types of case. Whether the respondents owe the appellants a duty of care for their allegedly negligent preparation of the 1980-82 audit reports, then, will depend on (a) whether a prima facie duty of care is owed, and (b) whether that duty, if it exists, is negatived or limited by policy considerations. Before analysing the merits of this case, it will be useful to set out in greater detail the principles governing this appeal.

(ii) The Prima Facie Duty of Care

22 The first branch of the Anns/Kamloops test demands an inquiry into whether there is a sufficiently close relationship between the plaintiff and the defendant that in the reasonable contemplation of the latter, carelessness on its part may cause damage to the former. The existence of such a relationship -- which has come to be known as a relationship of "neighbourhood" or "proximity" -- distinguishes those circumstances in which the defendant owes a prima facie duty of care to the plaintiff from those where no such duty exists. In the context of a negligent misrepresentation action, then, deciding whether or not a prima facie duty of care exists necessitates an investigation into whether the defendant-representor and the plaintiff-representee can be said to be in a relationship of proximity or neighbourhood.

23 What constitutes a "relationship of proximity" in the context of negligent misrepresentation actions? In approaching this question, I would begin by reiterating the position I took in Norsk, supra, at pp. 1114-15, that the term "proximity" itself is nothing more than a label expressing a result, judgment or conclusion; it does not, in and of itself, provide a principled basis on which to make a legal determination. This view was also explicitly adopted by Stevenson J. in Norsk, supra, at p. 1178, and McLachlin J. also appears to have accepted it when she wrote, at p. 1151, of that case that "[p]roximity may usefully be viewed, not so much as a test in itself, but as a broad concept which is capable of subsuming different categories of cases involving different factors"; see also: M. H. McHugh, "Neighbourhood, Proximity and Reliance", in P. D. Finn, ed., Essays on Torts (1989), 5, at pp. 36-37; and John G. Fleming, "The Negligent Auditor and Shareholders" (1990), 106 L.Q. Rev. 349, at p. 351, where the author refers to proximity as a "vacuous test". While Norsk, supra, was concerned specifically with whether or not a defendant could be held liable for "contractual relational economic loss" (as I called it, at p. 1037), I am of the view that the same observations with respect to the term "proximity" are applicable in the context of negligent misrepresentation. In order to render "proximity" a useful tool in defining when a duty of care exists in negligent misrepresentation cases, therefore, it is necessary to infuse that term with some meaning. In other words, it is necessary to set out the basis upon which one may properly reach the conclusion that proximity inheres between a representor and a representee.

24 This can be done most clearly as follows. The label "proximity", as it was used by Lord Wilberforce in Anns, supra, was clearly intended to connote that the circumstances of the relationship inhering between the plaintiff and the defendant are of such a nature that the defendant may be said to be under an obligation to be mindful of the plaintiff's legitimate interests in conducting his or her affairs. Indeed, this idea lies at the very heart of the concept of a "duty of care", as articulated most memorably by Lord Atkin in Donoghue v. Stevenson, [1932] A.C. 562, at pp. 580-81. In cases of negligent misrepresentation, the relationship between the plaintiff and the defendant arises through reliance by the plaintiff on the defendant's words. Thus, if "proximity" is meant to distinguish the cases where the defendant has a responsibility to take reasonable care of the plaintiff from those where he or she has no such responsibility, then in negligent misrepresentation cases, it must pertain to some aspect of the relationship of reliance. To my mind, proximity can be seen to inhere between a defendant-representor and a plaintiff-representee when two criteria relating to reliance may be said to exist on the facts: (a) the defendant ought reasonably to foresee that the plaintiff will rely on his or her representation; and (b) reliance by the plaintiff would, in the particular circumstances of the case, be reasonable. To use the term employed by my colleague, Iacobucci J., in Cognos, supra, at p. 110, the plaintiff and the defendant can be said to be in a "special relationship" whenever these two factors inhere.

25 I should pause here to explain that, in my view, to look to whether or not reliance by the plaintiff on the defendant's representation would be reasonable in determining whether or not a prima facie duty of care exists in negligent misrepresentation cases as opposed to looking at reasonable foreseeability alone is not, as might first appear, to abandon the basic tenets underlying the first branch of the Anns/Kamloops formula. The purpose behind the Anns/Kamloops test is simply to ensure that enquiries into the existence of a duty of care in negligence cases is conducted in two parts: The first involves discerning whether, in a given situation, a duty of care would be imposed by law; the second demands an investigation into whether the legal duty, if found, ought to be negatived or ousted by policy considerations. In the context of actions based on negligence causing physical damage, determining whether harm to the plaintiff was reasonably foreseeable to the defendant is alone a sufficient criterion for deciding proximity or neighbourhood under the first branch of the Anns/Kamloops test because the law has come to recognize (even if only implicitly) that, absent a voluntary assumption of risk by him or her, it is always reasonable for a plaintiff to expect that a defendant will take reasonable care of the plaintiff's person and property. The duty of care inquiry in such cases, therefore, will always be conducted under the assumption that the plaintiff's expectations of the defendant are reasonable.

26 In negligent misrepresentation actions, however, the plaintiff's claim stems from his or her detrimental reliance on the defendant's (negligent) statement, and it is abundantly clear that reliance on the statement or representation of another will not, in all circumstances, be reasonable. The assumption that always inheres in physical damage cases concerning the reasonableness of the plaintiff's expectations cannot, therefore, be said to inhere in reliance cases. In order to ensure that the same factors are taken into account in determining the existence of a duty of care in both instances, then, the reasonableness of the plaintiff's reliance must be considered in negligent misrepresentation actions. Only by doing so will the first branch of the Kamloops test be applied consistently in both contexts.

27 As should be evident from its very terms, the reasonable foreseeability/reasonable reliance test for determining a prima facie duty of care is somewhat broader than the tests used both in the cases decided before Anns, supra, and in those that have rejected the Anns approach. Rather than

stipulating simply that a duty of care will be found in any case where reasonable foreseeability and reasonable reliance inhere, those cases typically require (a) that the defendant know the identity of either the plaintiff or the class of plaintiffs who will rely on the statement, and (b) that the reliance losses claimed by the plaintiff stem from the particular transaction in respect of which the statement at issue was made. This narrower approach to defining the duty can be seen in a number of the more prominent English decisions dealing either with auditors' liability specifically or with liability for negligent misstatements generally. (See, e.g.: Candler v. Crane, Christmas & Co., [1951] 2 K.B. 164 (C.A.), at pp. 181-82 and p. 184, per Denning L.J. (dissenting); Hedley Byrne & Co. v. Heller & Partners Ltd., [1964] A.C. 465; Caparo, supra, per Lord Bridge, at p. 576, and per Lord Oliver, at pp. 589.) It is also evident in the approach taken by this Court in Haig v. Bamford, [1977] 1 S.C.R. 466.

28 While I would not question the conclusions reached in any of these judgments, I am of the view that inquiring into such matters as whether the defendant had knowledge of the plaintiff (or class of plaintiffs) and whether the plaintiff used the statements at issue for the particular transaction for which they were provided is, in reality, nothing more than a means by which to circumscribe -- for reasons of policy -- the scope of a representor's potentially infinite liability. As I have already tried to explain, determining whether "proximity" exists on a given set of facts consists in an attempt to discern whether, as a matter of simple justice, the defendant may be said to have had an obligation to be mindful of the plaintiff's interests in going about his or her business. Requiring, in addition to proximity, that the defendant know the identity of the plaintiff (or class of plaintiffs) and that the plaintiff use the statements in question for the specific purpose for which they were prepared amounts, in my opinion, to a tacit recognition that considerations of basic fairness may sometimes give way to other pressing concerns. Plainly stated, adding further requirements to the duty of care test provides a means by which policy concerns that are extrinsic to simple justice -- but that are, nevertheless, fundamentally important -- may be taken into account in assessing whether the defendant should be compelled to compensate the plaintiff for losses suffered. In other words, these further requirements serve a policy-based limiting function with respect to the ambit of the duty of care in negligent misrepresentation actions.

29 This view is confirmed by the judgments themselves. In Caparo, supra, at p. 576, for example, Lord Bridge refers to the criteria of knowledge of the plaintiff (or class of plaintiffs) and use of the statements for the intended transaction as a " 'limit or control mechanism . . . imposed on the liability of the wrongdoer towards those who have suffered some economic damage in consequence of his negligence'" (emphasis added). Similarly, in Haig, supra, at p. 476, Dickson J. (as he then was) explicitly discusses the policy concern arising from unlimited liability before finding that the statements at issue in Haig were used for the very purpose for which they were prepared and that the appropriate test for a duty of care in the case before him was "actual knowledge of the limited class that will use and rely on the statement". (See also Candler, supra, at p. 183, per Denning L.J. (dissenting).) Certain scholars have adopted this view of the case law as well. (See, e.g.: Bruce Feldthusen, Economic Negligence (3rd ed. 1994), at pp. 93-100, where the author explains that the approach taken in both Haig, supra, and Caparo, supra, toward defining the duty of care was motivated by underlying policy concerns; see also: Earl A. Cherniak and Kirk F. Stevens, "Two Steps Forward or One Step Back? Anns at the Crossroads in Canada" (1992), 20 C.B.L.J. 164, and Ivan F. Ivankovich, "Accountants and Third-Party Liability -- Back to the Future" (1991), 23 Ottawa L. Rev. 505, at p. 518.)

30 In light of this Court's endorsement of the Anns/Kamloops test, however, enquiries concerning (a) the defendant's knowledge of the identity of the plaintiff (or of the class of plaintiffs) and (b) the use to which the statements at issue are put may now quite properly be conducted in the second branch of that test when deciding whether or not policy considerations ought to negate or limit a prima facie duty that has already been found to exist. In other words, criteria that in other cases have been used to define the legal test for the duty of care can now be recognized for what they really are -- policy-based means by which to curtail liability -- and they can appropriately be considered under the policy branch of the Anns/Kamloops test. To understand exactly how this may be done and how these criteria are pertinent to the case at bar, it will first be useful to set out the prevailing policy concerns in some detail.

(iii) Policy Considerations

31 As Cardozo C.J. explained in Ultramares Corp. v. Touche, 174 N.E. 441 (N.Y.C.A. 1931), at p. 444, the fundamental policy consideration that must be addressed in negligent misrepresentation actions centres around the possibility that the defendant might be exposed to "liability in an indeterminate amount for an indeterminate time to an indeterminate class". This potential problem can be seen quite vividly within the framework of the Anns/Kamloops test. Indeed, while the criteria of reasonable foreseeability and reasonable reliance serve to distinguish cases where a prima facie duty is owed from those where it is not, it is nevertheless true that in certain types of situations these criteria can, quite easily, be satisfied and absent some means by which to circumscribe the ambit of the duty, the prospect of limitless liability will loom.

32 The general area of auditors' liability is a case in point. In modern commercial society, the fact that audit reports will be relied on by many different people (e.g., shareholders, creditors, potential takeover bidders, investors, etc.) for a wide variety of purposes will almost always be reasonably foreseeable to auditors themselves. Similarly, the very nature of audited financial statements -- produced, as they are, by professionals whose reputations (and, thereby, whose livelihoods) are at stake -- will very often mean that any of those people would act wholly reasonably in placing their reliance on such statements in conducting their affairs. These observations are consistent with the following remarks of Dickson J. in Haig, supra, at pp. 475-76, with respect to the accounting profession generally:

> The increasing growth and changing role of corporations in modern society has been attended by a new perception of the societal role of the profession of accounting. The day when the accountant served only the owner-manager of a company and was answerable to him alone has passed. The complexities of modern industry combined with the effects of specialization, the impact of taxation, urbanization, the separation of ownership from management, the rise of professional corporate managers, and a host of other factors, have led to marked changes in the role and responsibilities of the accountant, and in the reliance which the public must place upon his work. The financial statements of the corporations upon which he reports can affect the economic interests of the general public as well as of shareholders and potential shareholders.

(See also: Cherniak and Stevens, supra, at pp. 169-70.) In light of these considerations, the reasonable foreseeability/reasonable reliance test for ascertaining a prima facie duty of care may well be

satisfied in many (even if not all) negligent misstatement suits against auditors and, consequently, the problem of indeterminate liability will often arise.

33 Certain authors have argued that imposing broad duties of care on auditors would give rise to significant economic and social benefits in so far as the spectre of tort liability would act as an incentive to auditors to produce accurate (i.e., non-negligent) reports. (See, e.g.: Howard B. Wiener, "Common Law Liability of the Certified Public Accountant for Negligent Misrepresentation" (1983), 20 San Diego L. Rev. 233.) I would agree that deterrence of negligent conduct is an important policy consideration with respect to auditors' liability. Nevertheless, I am of the view that, in the final analysis, it is outweighed by the socially undesirable consequences to which the imposition of indeterminate liability on auditors might lead. Indeed, while indeterminate liability is problematic in and of itself inasmuch as it would mean that successful negligence actions against auditors could, at least potentially, be limitless, it is also problematic in light of certain related problems to which it might give rise.

34 Some of the more significant of these problems are thus set out in Brian R. Cheffins, "Auditors' Liability in the House of Lords: A Signal Canadian Courts Should Follow" (1991), 18 C.B.L.J. 118, at pp. 125-27:

> In addition to providing only limited benefits, imposing widely drawn duties of care on auditors would probably generate substantial costs. . . .
>
> One reason [for this] is that auditors would expend more resources trying to protect themselves from liability. For example, insurance premiums would probably rise since insurers would anticipate more frequent claims. Also, auditors would probably incur higher costs since they would try to rely more heavily on exclusion clauses. Hiring lawyers to draft such clauses might be expensive because only the most carefully constructed provisions would be likely to pass judicial scrutiny. . . .
>
> Finally, auditors' opportunity costs would increase. Whenever members of an accounting firm have to spend time and effort preparing for litigation, they forego revenue generating accounting activity. More trials would mean that this would occur with greater frequency.
>
> . . .
>
> The higher costs auditors would face as a result of broad duties of care could have a widespread impact. For example, the supply of accounting services would probably be reduced since some marginal firms would be driven to the wall. Also, because the market for accounting services is protected by barriers to entry imposed by the profession, the surviving firms would pass [sic] at least some of the increased costs to their clients.

Professor Ivankovich describes similar sources of concern. While he acknowledges certain social benefits to which expansive auditors' liability might conduce, he also recognizes the potential difficulties associated therewith (at pp. 520-21):

> . . . [expansive auditors' liability] is also likely to increase the time expended in the performance of accounting services. This will trigger a predictable negative impact on the timeliness of the financial information generated. It is equally likely to increase the cost of professional liability insurance and reduce its availability, and to increase the cost of accounting services which, as a result, may become less generally available. Additionally, it promotes "free ridership" on the part of reliant third parties and decreases their incentive to exercise greater vigilance and care and, as well, presents an increased risk of fraudulent claims.

Even though I do not share the discomfort apparently felt by Professors Cheffins and Ivankovich with respect to using an Anns-type test in the context of negligent misrepresentation actions (See: Cheffins, supra, at pp. 129-31, and Ivankovich, supra, at p. 530), I nevertheless agree with their assessment of the possible consequences to both auditors and the public generally if liability for negligently prepared audit reports were to go unchecked.

35 I should, at this point, explain that I am aware of the arguments put forth by certain scholars and judges to the effect that concerns over indeterminate liability have sometimes been overstated. (See, e.g.: J. Edgar Sexton and John W. Stevens, "Accountants' Legal Responsibilities and Liabilities", in Professional Responsibility in Civil Law and Common Law (Meredith Memorial Lectures, McGill University, 1983-84) (1985), 88, at pp. 101-2; and H. Rosenblum (1983), Inc. v. Adler, 461 A.2d 138 (N.J. 1983), at p. 152, per Schreiber J.) Arguments to this effect rest essentially on the premise that actual liability will be limited in so far as a plaintiff will not be successful unless both negligence and reliance are established in addition to a duty of care. While it is true that damages will not be owing by the defendant unless these other elements of the cause of action are proved, neither the difficulty of proving negligence nor that of proving reliance will preclude a disgruntled plaintiff from bringing an action against an auditor and such actions would, we may assume, be all the more common were the establishment of a duty of care in any given case to amount to nothing more than a mere matter of course. This eventuality could pose serious problems both for auditors, whose legal costs would inevitably swell, and for courts, which, no doubt, would feel the pressure of increased litigation. Thus, the prospect of burgeoning negligence suits raises serious concerns, even if we assume that the arguments positing proof of negligence and reliance as a barrier to liability are correct. In my view, therefore, it makes more sense to circumscribe the ambit of the duty of care than to assume that difficulties in proving negligence and reliance will afford sufficient protection to auditors, since this approach avoids both "indeterminate liability" and "indeterminate litigation".

36 As I have thus far attempted to demonstrate, the possible repercussions of exposing auditors to indeterminate liability are significant. In applying the two-stage Anns/Kamloops test to negligent misrepresentation actions against auditors, therefore, policy considerations reflecting those repercussions should be taken into account. In the general run of auditors' cases, concerns over indeterminate liability will serve to negate a prima facie duty of care. But while such concerns may exist in most such cases, there may be particular situations where they do not. In other words, the specific factual matrix of a given case may render it an "exception" to the general class of cases in that while (as in most auditors' liability cases) considerations of proximity under the first branch of the Anns/Kamloops test might militate in favour of finding that a duty of care inheres, the typical concerns surrounding indeterminate liability do not arise. This needs to be explained.

37 As discussed earlier, looking to factors such as "knowledge of the plaintiff (or an identifiable class of plaintiffs) on the part of the defendant" and "use of the statements at issue for the precise purpose or transaction for which they were prepared" really amounts to an attempt to limit or constrain the scope of the duty of care owed by the defendants. If the purpose of the Anns/Kamloops test is to determine (a) whether or not a prima facie duty of care exists and then (b) whether or not that duty ought to be negated or limited, then factors such as these ought properly to be considered in the second branch of the test once the first branch concerning "proximity" has been found to be satisfied. To my mind, the presence of such factors in a given situation will mean that worries stemming from indeterminacy should not arise, since the scope of potential liability is sufficiently delimited. In other words, in cases where the defendant knows the identity of the plaintiff (or of a class of plaintiffs) and where the defendant's statements are used for the specific purpose or transaction for which they were made, policy considerations surrounding indeterminate liability will not be of any concern since the scope of liability can readily be circumscribed. Consequently, such considerations will not override a positive finding on the first branch of the Anns/Kamloops test and a duty of care may quite properly be found to exist.

38 As I see it, this line of reasoning serves to explain the holding of Cardozo J. (as he then was) in Glanzer v. Shepard, 135 N.E. 275 (N.Y.C.A. 1922) . There, the New York Court of Appeals held that the defendant weigher was liable in damages for having negligently prepared a weight certificate he knew would be given to the plaintiff, who relied upon it for the specific purpose for which it was issued. In reaching his decision, Cardozo J. explicitly noted that the weight certificate was used for the very "end and aim of the transaction" and not for any collateral or unintended purpose (Glanzer, supra, at p. 275). On the facts of Glanzer, supra, then, the scope of the defendant's liability could readily be delimited and indeterminacy, therefore, was not a concern.

39 The same idea serves to explain the rationale underlying the seminal judgment of the House of Lords in Hedley Byrne, supra. While that case did not involve an action against auditors, similar concerns about indeterminate liability were, nonetheless, clearly relevant. On the facts of Hedley Byrne, supra, the defendant bank provided a negligently prepared credit reference in respect of one of its customers to another bank which, to the knowledge of the defendants, passed on the information to the plaintiff for a stipulated purpose. The plaintiff relied on the credit reference for the specific purpose for which it was prepared. The House of Lords found that but for the presence of a disclaimer, the defendants would have been liable to the plaintiff in negligence. While indeterminate liability would have raised some concern to the Lords had the plaintiff not been known to the defendants or had the credit reference been used for a purpose or transaction other than that for which it was actually prepared, no such difficulties about indeterminacy arose on the particular facts of the case.

40 This Court's decision in Haig, supra, can be seen to rest on precisely the same basis. There, the defendant accountants were retained by a Saskatchewan businessman, one Scholler, to prepare audited financial statements of Mr. Scholler's corporation. At the time they were engaged, the accountants were informed by Mr. Scholler that the audited statements would be used for the purpose of attracting a $20,000 investment in the corporation from a limited number of potential investors. The audit was conducted negligently and the plaintiff investor, who was found to have relied on the audited statements in making his investment, suffered a loss. While Dickson J. was clearly cognizant of the potential problem of indeterminacy arising in the context of auditors' liability (at p. 476), he nevertheless found that the defendants owed the plaintiff a duty of care. In my view, his conclusion was eminently sound given that the defendants were informed by Mr. Scholler of the class of

persons who would rely on the report and the report was used by the plaintiff for the specific purpose for which it was prepared. Dickson J. himself expressed this idea as follows, at p. 482:

> The case before us is closer to Glanzer than to Ultramares. The very end and aim of the financial statements prepared by the accountants in the present case was to secure additional financing for the company from [a Saskatchewan government agency] and an equity investor; the statements were required primarily for these third parties and only incidentally for use by the company.

On the facts of Haig, then, the auditors were properly found to owe a duty of care because concerns over indeterminate liability did not arise. I would note that this view of the rationale behind Haig, supra, is shared by Professor Feldthusen. (See Feldthusen, supra, at pp. 98-100.)

41 The foregoing analysis should render the following points clear. A prima facie duty of care will arise on the part of a defendant in a negligent misrepresentation action when it can be said (a) that the defendant ought reasonably to have foreseen that the plaintiff would rely on his representation and (b) that reliance by the plaintiff, in the circumstances, would be reasonable. Even though, in the context of auditors' liability cases, such a duty will often (even if not always) be found to exist, the problem of indeterminate liability will frequently result in the duty being negated by the kinds of policy considerations already discussed. Where, however, indeterminate liability can be shown not to be a concern on the facts of a particular case, a duty of care will be found to exist. Having set out the law governing the appellants' claims, I now propose to apply it to the facts of the appeal.

(iv) Application to the Facts

42 In my view, there can be no question that a prima facie duty of care was owed to the appellants by the respondents on the facts of this case. As regards the criterion of reasonable foreseeability, the possibility that the appellants would rely on the audited financial statements in conducting their affairs and that they may suffer harm if the reports were negligently prepared must have been reasonably foreseeable to the respondents. This is confirmed simply by the fact that shareholders generally will often choose to rely on audited financial statements for a wide variety of purposes. It is further confirmed by the fact that under ss. 149(1) and 163(1) of the Manitoba Corporations Act, it is patently clear that audited financial statements are to be placed before the shareholders at the annual general meeting. The relevant portions of those sections read as follows:

> 149(1) The directors of a corporation shall place before the shareholders at every annual meeting
>
> . . .
>
> (b) the report of the auditor, if any; and
>
> . . .
>
> 163(1) An auditor of a corporation shall make the examination that is in his opinion necessary to enable him to report in the prescribed manner on the financial statements required by this Act to be placed before the shareholders, except

such financial statements or part thereof as relate to the period referred to in sub-clause 149(1)(a)(ii).

In my view, it would be untenable to argue in the face of these provisions that some form of reliance by shareholders on the audited reports would be unforeseeable.

43 Similarly, I would find that reliance on the audited statements by the appellant shareholders would, on the facts of this case, be reasonable. Professor Feldthusen (at pp. 62-63) sets out five general indicia of reasonable reliance; namely:

(1) The defendant had a direct or indirect financial interest in the transaction in respect of which the representation was made.
(2) The defendant was a professional or someone who possessed special skill, judgment, or knowledge.
(3) The advice or information was provided in the course of the defendant's business.
(4) The information or advice was given deliberately, and not on a social occasion.
(5) The information or advice was given in response to a specific enquiry or request.

While these indicia should not be understood to be a strict "test" of reasonableness, they do help to distinguish those situations where reliance on a statement is reasonable from those where it is not. On the facts here, the first four of these indicia clearly inhere. To my mind, then, this aspect of the prima facie duty is unquestionably satisfied on the facts.

44 Having found a prima facie duty to exist, then, the second branch of the Anns/Kamloops test remains to be considered. It should be clear from my comments above that were auditors such as the respondents held to owe a duty of care to plaintiffs in all cases where the first branch of the Anns/Kamloops test was satisfied, the problem of indeterminate liability would normally arise. It should be equally clear, however, that in certain cases, this problem does not arise because the scope of potential liability can adequately be circumscribed on the facts. An investigation of whether or not indeterminate liability is truly a concern in the present case is, therefore, required.

45 At first blush, it may seem that no problems of indeterminate liability are implicated here and that this case can easily be likened to Glanzer, supra, Hedley Byrne, supra, and Haig, supra. After all, the respondents knew the very identity of all the appellant shareholders who claim to have relied on the audited financial statements through having acted as NGA's and NGH's auditors for nearly 10 years by the time the first of the audit reports at issue in this appeal was prepared. It would seem plausible to argue on this basis that because the identity of the plaintiffs was known to the respondents at the time of preparing the 1980-82 reports, no concerns over indeterminate liability arise.

46 To arrive at this conclusion without further analysis, however, would be to move too quickly. While knowledge of the plaintiff (or of a limited class of plaintiffs) is undoubtedly a significant factor serving to obviate concerns over indeterminate liability, it is not, alone, sufficient to do so. In my discussion of Glanzer, supra, Hedley Byrne, supra, and Haig, supra, I explained that indeterminate liability did not inhere on the specific facts of those cases not only because the defendant knew the identity of the plaintiff (or the class of plaintiffs) who would rely on the statement

at issue, but also because the statement itself was used by the plaintiff for precisely the purpose or transaction for which it was prepared. The crucial importance of this additional criterion can clearly be seen when one considers that even if the specific identity or class of potential plaintiffs is known to a defendant, use of the defendant's statement for a purpose or transaction other than that for which it was prepared could still lead to indeterminate liability.

47 For example, if an audit report which was prepared for a corporate client for the express purpose of attracting a $10,000 investment in the corporation from a known class of third parties was instead used as the basis for attracting a $1,000,000 investment or as the basis for inducing one of the members of the class to become a director or officer of the corporation or, again, as the basis for encouraging him or her to enter into some business venture with the corporation itself, it would appear that the auditors would be exposed to a form of indeterminate liability, even if they knew precisely the identity or class of potential plaintiffs to whom their report would be given. With respect to the present case, then, the central question is whether or not the appellants can be said to have used the 1980-82 audit reports for the specific purpose for which they were prepared. The answer to this question will determine whether or not policy considerations surrounding indeterminate liability ought to negate the prima facie duty of care owed by the respondents.

48 What, then, is the purpose for which the respondents' audit statements were prepared? This issue was eloquently discussed by Lord Oliver in Caparo, supra, at p. 583:

> My Lords, the primary purpose of the statutory requirement that a company's accounts shall be audited annually is almost self-evident. . . . The management is confided to a board of directors which operates in a fiduciary capacity and is answerable to and removable by the shareholders who can act, if they act at all, only collectively and only through the medium of a general meeting. Hence the legislative provisions requiring the board annually to give an account of its stewardship to a general meeting of the shareholders. This is the only occasion in each year on which the general body of shareholders is given the opportunity to consider, to criticise and to comment on the conduct by the board of the company's affairs, to vote the directors' recommendation as to dividends, to approve or disapprove the directors' remuneration and, if thought desirable, to remove and replace all or any of the directors. It is the auditors' function to ensure, so far as possible, that the financial information as to the company's affairs prepared by the directors accurately reflects the company's position in order first, to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing . . . and, second, to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinise the conduct of the company's affairs and to exercise their collective powers to reward or control or remove those to whom that conduct has been confided. [Emphasis added.]

Similarly, Farley J. held in Roman Corp. Ltd. v. Peat Marwick Thorne (1992), 11 O.R. (3d) 248 (Gen. Div.), at p. 260 (hereinafter Roman I) that

> as a matter of law the only purpose for which shareholders receive an auditor's report is to provide the shareholders with information for the purpose of overseeing the management and affairs of the corporation and not for the purpose of

> guiding personal investment decisions or personal speculation with a view to profit.

(See also: Roman Corp. v. Peat Marwick Thorne (1993), 12 B.L.R. (2d) 10 (Ont. Gen. Div.).) Lord Oliver was referring to the relevant provisions of the U.K. Companies Act 1985 (U.K.), 1985, c. 6, in making his pronouncements, and Farley J. rendered his judgment against the backdrop of the statutory audit requirements set out in the Ontario Business Corporations Act, R.S.O. 1990, c. B.16.

49 To my mind, the standard purpose of providing audit reports to the shareholders of a corporation should be regarded no differently under the analogous provisions of the Manitoba Corporations Act. Thus, the directors of a corporation are required to place the auditors' report before the shareholders at the annual meeting in order to permit the shareholders, as a body, to make decisions as to the manner in which they want the corporation to be managed, to assess the performance of the directors and officers, and to decide whether or not they wish to retain the existing management or to have them replaced. On this basis, it may be said that the respondent auditors' purpose in preparing the reports at issue in this case was, precisely, to assist the collectivity of shareholders of the audited companies in their task of overseeing management.

50 The appellants, however, submit that, in addition to this statutorily mandated purpose, the respondents further agreed to perform their audits for the purpose of providing the appellants with information on the basis of which they could make personal investment decisions. They base this claim largely on a conversation that allegedly took place at the 1978 meeting between Mr. Cox, Mr. Freed and Mr. Korn, as well as on certain passages of the engagement letter sent to them by the respondents. I have read the relevant portions of the record on this question and I am unable to accept the appellants' submission. Indeed, on examination for discovery, Mr. Freed discussed the engagement letter of the respondents and stated as follows:

> Q It is this that you say is the document that says, it will speak for itself, but you interpret it to mean that they [the respondents] will look after your interests specifically [sic]? . . .
>
> A I am saying that I took for granted that that was their duty.
>
> Q I see. All right. Was there ever anything in writing specifically that says that is your duty, is to look after my interests, I am away all the time?
>
> A I am not aware.
>
> Q Either, from you, or to you in that respect?

A I am not aware of any.

Q This letter happens to say, "We are always prepared upon instruction to extend our services beyond these required procedures." Did you ever give them any additional instructions?

A No. I never saw them.

Q Nor did you communicate with them in writing, or otherwise? Is that right?

A Not that I recall.

Similarly, the transcript of Mr. Korn's examination for discovery reveals the following exchange:

Q You emphasized [at the 1978 meeting] you say to Mr. Cox that because you were no longer in the management stream or chain, you would be relying more on the audited statements?

A Yes, and that -- well, I wanted a sort of commitment that he understood that he was the shareholders' auditor and I did refer to the fact that he had [a] close personal association with Mr. Morris and he said no, he fully understood, have no fear.

Q Did you consider that to be a change from the normal kind of audit engagement, or were you just emphasizing something that was part of the normal audit engagement?

A I just pointed out the change. As a matter of fact, he already knew about the change.

. . .

Q But my question was whether you considered that to be any kind of alteration from the usual audit engagement process.

A Well, that's what happened. That's the fact that I said it to him and those are the words I said, and however he took it, that's however he took it.

Q But I'm asking you if you considered that to be a change from a normal audit engagement.

A Well, I'm not -- whether that was -- whether those words were some sort of special instructions, those were the words and I guess there will be experts to say what consequences should have flown [sic] from them, and I'm not here as an expert on audit --

Q I'm entitled to know what you consider to be the case.

A Well, I made it clear that he should remember that he's the shareholders' auditor, that Clarkson was the shareholders' auditor, notwithstanding his personal relationship with Murray Morris.

Q Auditors are always the shareholders' auditors, are they not?

A And that's what I -- if they are, they are.

Q And that's in fact what they are always?

A Well, that's good, I'm glad to hear that, glad to hear you say it.

Q Do you agree?

A That the auditors are the shareholders' auditors?

Q Yes.

A I agree precisely.

To my mind, these passages serve to demonstrate that despite the appellants' submissions, the respondents did not, in fact, prepare the audit reports in order to assist the appellants in making personal investment decisions or, indeed, for any purpose other than the standard statutory one. This finding accords with that of Helper J.A. in the Court of Appeal, and nothing in the record before this Court suggests the contrary.

51 It follows from the foregoing discussion that the only purpose for which the 1980-82 reports could have been used in such a manner as to give rise to a duty of care on the part of the respondents is as a guide for the shareholders, as a group, in supervising or overseeing management. In assessing whether this was, in fact, the purpose to which the appellants purport to have put the audited reports, it will be useful to take each of the appellants' claims in turn. First, the appellant Hercules seeks compensation for its $600,000 injection of capital into NGA over January and February of 1983 and the appellant Freed seeks damages commensurate with the amount of money he contributed in 1982 to his investment account in NGH. Secondly, all the appellants seek damages for the losses they suffered in the value of their existing shareholdings.

52 The claims of Hercules and Mr. Freed with respect to their 1982-83 investments can be addressed quickly. The essence of these claims must be that these two appellants relied on the respondents' reports in deciding whether or not to make further investments in the audited corporations. In other words, Hercules and Mr. Freed are claiming to have relied on the audited reports for the purpose of making personal investment decisions. As I have already discussed, this is not a purpose for which the respondents in this case can be said to have prepared their reports. In light of the dissonance between the purpose for which the reports were actually prepared and the purpose for which the appellants assert they were used, then, the claims of Hercules and Mr. Freed with respect to their investment losses are not such that the concerns over indeterminate liability discussed above are obviated; viz., if a duty of care were owed with respect to these investment transactions, there would seem to be no logical reason to preclude a duty of care from arising in circumstances where the statements were used for any other purpose of which the auditors were equally unaware when they prepared and submitted their report. On this basis, therefore, I would find that the prima facie duty that arises respecting this claim is negated by policy considerations and, therefore, that no duty of care is owed by the respondents in this regard.

53 With respect to the claim concerning the loss in value of their existing shareholdings, the appellants make two submissions. First, they claim that they relied on the 1980-82 reports in monitoring the value of their equity and that, owing to the (allegedly) negligent preparation of those reports, they failed to extract it before the financial demise of NGA and NGH. Secondly, and somewhat more subtly, the appellants submit that they each relied on the auditors' reports in overseeing

the management of NGA and NGH and that had those reports been accurate, the collapse of the corporations and the consequential loss in the value of their shareholdings could have been avoided.

54 To my mind, the first of these submissions suffers from the same difficulties as those regarding the injection of fresh capital by Hercules and Mr. Freed. Whether the reports were relied upon in assessing the prospect of further investments or in evaluating existing investments, the fact remains that the purpose to which the respondents' reports were put, on this claim, concerned individual or personal investment decisions. Given that the reports were not prepared for that purpose, I find for the same reasons as those earlier set out that policy considerations regarding indeterminate liability inhere here and, consequently, that no duty of care is owed in respect of this claim.

55 As regards the second aspect of the appellants' claim concerning the losses they suffered in the diminution in value of their equity, the analysis becomes somewhat more intricate. The essence of the appellants' submission here is that the shareholders would have supervised management differently had they known of the (alleged) inaccuracies in the 1980-82 reports, and that this difference in management would have averted the demise of the audited corporations and the consequent losses in existing equity suffered by the shareholders. At first glance, it might appear that the appellants' claim implicates a use of the audit reports which is commensurate with the purpose for which the reports were prepared, i.e., overseeing or supervising management. One might argue on this basis that a duty of care should be found to inhere because, in view of this compatibility between actual use and intended purpose, no indeterminacy arises. In my view, however, this line of reasoning suffers from a subtle but fundamental flaw.

56 As I have already explained, the purpose for which the audit reports were prepared in this case was the standard statutory one of allowing shareholders, as a group, to supervise management and to take decisions with respect to matters concerning the proper overall administration of the corporations. In other words, it was, as Lord Oliver and Farley J. found in the cases cited above, to permit the shareholders to exercise their role, as a class, of overseeing the corporations' affairs at their annual general meetings. The purpose of providing the auditors' reports to the appellants, then, may ultimately be said to have been a "collective" one; that is, it was aimed not at protecting the interests of individual shareholders but rather at enabling the shareholders, acting as a group, to safeguard the interests of the corporations themselves. On the appellants' argument, however, the purpose to which the 1980-82 reports were ostensibly put was not that of allowing the shareholders as a class to take decisions in respect of the overall running of the corporation, but rather to allow them, as individuals, to monitor management so as to oversee and protect their own personal investments. Indeed, the nature of the appellants' claims (i.e. personal tort claims) requires that they assert reliance on the auditors' reports qua individual shareholders if they are to recover any personal damages. In so far as it must concern the interests of each individual shareholder, then, the appellants' claim in this regard can really be no different from the other "investment purposes" discussed above, in respect of which the respondents owe no duty of care.

57 This argument is no different as regards the specific case of the appellant Guardian, which is the sole shareholder of NGH. The respondents' purpose in providing the audited reports in respect of NGH was, we must assume, to allow Guardian to oversee management for the better administration of the corporation itself. If Guardian in fact chose to rely on the reports for the ultimate purpose of monitoring its own investment it must, for the policy reasons earlier set out, be found to have done so at its own peril in the same manner as shareholders in NGA. Indeed, to treat Guardian any differently simply because it was a sole shareholder would do violence to the fundamental principle

of corporate personality. I would find in respect of both Guardian and the other appellants, therefore, that the prima facie duty of care owed to them by the respondents is negated by policy considerations in that the claims are not such as to bring them within the "exceptional" cases discussed above.

Issue 2: The Effect of the Rule in Foss v. Harbottle

58 All the participants in this appeal -- the appellants, the respondents, and the intervener -- raised the issue of whether the appellants' claims in respect of the losses they suffered in their existing shareholdings through their alleged inability to oversee management of the corporations ought to have been brought as a derivative action in conformity with the rule in Foss v. Harbottle rather than as a series of individual actions. The issue was also raised and discussed in the courts below. In my opinion, a derivative action -- commenced, as required, by an application under s. 232 of the Manitoba Corporations Act -- would have been the proper method of proceeding with respect to this claim. Indeed, I would regard this simply as a corollary of the idea that the audited reports are provided to the shareholders as a group in order to allow them to take collective (as opposed to individual) decisions. Let me explain.

59 The rule in Foss v. Harbottle provides that individual shareholders have no cause of action in law for any wrongs done to the corporation and that if an action is to be brought in respect of such losses, it must be brought either by the corporation itself (through management) or by way of a derivative action. The legal rationale behind the rule was eloquently set out by the English Court of Appeal in Prudential Assurance Co. v. Newman Industries Ltd. (No. 2), [1982] 1 All E.R. 354, at p. 367, as follows:

> The rule [in Foss v. Harbottle] is the consequence of the fact that a corporation is a separate legal entity. Other consequences are limited liability and limited rights. The company is liable for its contracts and torts; the shareholder has no such liability. The company acquires causes of action for breaches of contract and for torts which damage the company. No cause of action vests in the shareholder. When the shareholder acquires a share he accepts the fact that the value of his investment follows the fortunes of the company and that he can only exercise his influence over the fortunes of the company by the exercise of his voting rights in general meeting. The law confers on him the right to ensure that the company observes the limitations of its memorandum of association and the right to ensure that other shareholders observe the rule, imposed on them by the articles of association. If it is right that the law has conferred or should in certain restricted circumstances confer further rights on a shareholder the scope and consequences of such further rights require careful consideration.

To these lucid comments, I would respectfully add that the rule is also sound from a policy perspective, inasmuch as it avoids the procedural hassle of a multiplicity of actions.

60 The manner in which the rule in Foss v. Harbottle, supra, operates with respect to the appellants' claims can thus be demonstrated. As I have already explained, the appellants allege that they were prevented from properly overseeing the management of the audited corporations because the

respondents' audit reports painted a misleading picture of their financial state. They allege further that had they known the true situation, they would have intervened to avoid the eventuality of the corporations' going into receivership and the consequent loss of their equity. The difficulty with this submission, I have suggested, is that it fails to recognize that in supervising management, the shareholders must be seen to be acting as a body in respect of the corporation's interests rather than as individuals in respect of their own ends. In a manner of speaking, the shareholders assume what may be seen to be a "managerial role" when, as a collectivity, they oversee the activities of the directors and officers through resolutions adopted at shareholder meetings. In this capacity, they cannot properly be understood to be acting simply as individual holders of equity. Rather, their collective decisions are made in respect of the corporation itself. Any duty owed by auditors in respect of this aspect of the shareholders' functions, then, would be owed not to shareholders qua individuals, but rather to all shareholders as a group, acting in the interests of the corporation. And if the decisions taken by the collectivity of shareholders are in respect of the corporation's affairs, then the shareholders' reliance on negligently prepared audit reports in taking such decisions will result in a wrong to the corporation for which the shareholders cannot, as individuals, recover.

61 This line of reasoning finds support in Lord Bridge's comments in Caparo, supra, at p. 580:

> The shareholders of a company have a collective interest in the company's proper management and in so far as a negligent failure of the auditor to report accurately on the state of the company's finances deprives the shareholders of the opportunity to exercise their powers in general meeting to call the directors to book and to ensure that errors in management are corrected, the shareholders ought to be entitled to a remedy. But in practice no problem arises in this regard since the interest of the shareholders in the proper management of the company's affairs is indistinguishable from the interest of the company itself and any loss suffered by the shareholders . . . will be recouped by a claim against the auditor in the name of the company, not by individual shareholders. [Emphasis added.]

It is also reflected in the decision of Farley J. in Roman I, supra, the facts of which were similar to those of the case at bar. In that case, the plaintiff shareholders brought an action against the defendant auditors alleging, inter alia, that the defendant's audit reports were negligently prepared. That negligence, the shareholders contended, prevented them from properly overseeing management which, in turn, led to the winding up of the corporation and a loss to the shareholders of their equity therein. Farley J. discussed the rule in Foss v. Harbottle and concluded that it operated so as to preclude the shareholders from bringing personal actions based on an alleged inability to supervise the conduct of management.

62 One final point should be made here. Referring to the case of Goldex Mines Ltd. v. Revill (1974), 7 O.R. (2d) 216 (C.A.), the appellants submit that where a shareholder has been directly and individually harmed, that shareholder may have a personal cause of action even though the corporation may also have a separate and distinct cause of action. Nothing in the foregoing paragraphs should be understood to detract from this principle. In finding that claims in respect of losses stemming from an alleged inability to oversee or supervise management are really derivative and not personal in nature, I have found only that shareholders cannot raise individual claims in respect of a wrong done to the corporation. Indeed, this is the limit of the rule in Foss v. Harbottle. Where, however, a separate and distinct claim (say, in tort) can be raised with respect to a wrong done to a

shareholder qua individual, a personal action may well lie, assuming that all the requisite elements of a cause of action can be made out.

63 The facts of Haig, supra, provide the basis for an example of where such a claim might arise. Had the investors in that case been shareholders of the corporation, and had a similarly negligent report knowingly been provided to them by the auditors for a specified purpose, a duty of care separate and distinct from any duty owed to the audited corporation would have arisen in their favour, just as one arose in favour of Mr. Haig. While the corporation would have been entitled to claim damages in respect of any losses it might have suffered through reliance on the report (assuming, of course, that the report was also provided for the corporation's use), the shareholders in question would also have been able to seek personal compensation for the losses they suffered qua individuals through their personal reliance and investment. On the facts of this case, however, no claims of this sort can be established.

Conclusion

64 In light of the foregoing, I would find that even though the respondents owed the appellants (qua individual claimants) a prima facie duty of care both with respect to the 1982-83 investments made in NGA and NGH by Hercules and Mr. Freed and with respect to the losses they incurred through the devaluation of their existing shareholdings, such prima facie duties are negated by policy considerations which are not obviated by the facts of the case. Indeed, to come to the opposite conclusion on these facts would be to expose auditors to the possibility of indeterminate liability, since such a finding would imply that auditors owe a duty of care to any known class of potential plaintiffs regardless of the purpose to which they put the auditors' reports. This would amount to an unacceptably broad expansion of the bounds of liability drawn by this Court in Haig, supra. With respect to the claim regarding the appellants' inability to oversee management properly, I would agree with the courts below that it ought to have been brought as a derivative action. On the basis of these considerations, I would find under Rule 20.03(1) of the Manitoba Court of Queen's Bench Rules that the appellants have failed to establish that their claims as alleged would have "a real chance of success".

65 I would dismiss the appeal with costs.

cp/d/hbb/DRS/DRS

Tab 3

2010 CarswellOnt 8655, 2010 ONSC 6229, 75 B.L.R. (4th) 302, 71 C.B.R. (5th) 153

2010 CarswellOnt 8655, 2010 ONSC 6229, 75 B.L.R. (4th) 302, 71 C.B.R. (5th) 153

Nelson Financial Group Ltd., Re

IN THE MATTER OF THE COMPANIES' CREDITORS ARRANGEMENT ACT, R.S.C. 1985, C-36, AS AMENDED AND IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF NELSON FINANCIAL GROUP LTD.

Ontario Superior Court of Justice [Commercial List]

Pepall J.

Judgment: November 16, 2010
Docket: 10-8630-00CL

Counsel: Richard B. Jones, Douglas Turner, Q.C. for Noteholders / Moving Party

J.H. Grout, S. Aggarwal for Monitor

Pamela Foy for Ontario Securities Commission

Frank Lamie for Nelson Financial Group Ltd.

Robert Benjamin Mills, Harold Van Winssen for Respondents, Clifford Styles, Jackie Styles, Play Investments Ltd.

Michael Beardsley, Respondent for himself

Clifford Holland, Respondent for himself

Arnold Bolliger, Respondent for himself

John McVey, Respondent for himself

Joan Frederick, Respondent for herself

Rakesh Sharma, Respondent for himself

Larry Debono, Respondent for himself

Keith McClear, Respondent for himself

Subject: Corporate and Commercial; Insolvency

Business associations --- Specific matters of corporate organization — Shareholders — General principles — Whether creditor of corporation

N Ltd. raised funds by issuing promissory notes bearing 12 percent annual return and issued preference shares with typical annual dividend of 10 percent — Funds were then lent out at much higher interest rates — N Ltd. sought protection of Companies' Creditors Arrangement Act — Preferred shareholders alleged, inter alia, theft, fraud, misrepresentation, breach of trust, excessive dividend payments, conversion of notes into preferred shares while N Ltd. was insolvent, oppression, and breach of fiduciary duties against N Ltd. — Promissory note holders brought motion to have all claims of preferred shareholders against N Ltd. classified as equity claims within meaning of Act; and requesting that unsecured creditors be entitled to be paid in full before preferred shareholders and other relief — Motion granted, subject to two possible exceptions — Claims of preferred shareholders fell within ambit of s. 2 of Act, were governed by ss. 6(8) and 22.1 of Act, and therefore did not constitute claims provable for purposes of statute — Preferred shareholders were not creditors of N Ltd. — Shares were treated as equity in N Ltd.'s financial statements and in its books and records — Substance of arrangement between preferred shareholders and N Ltd. was relationship based on equity, not debt — Pursuant to ss. 6(8) and 22.1, equity claims are rendered subordinate to those of creditors — Types of claims advanced by preferred shareholders were captured by language of recent amendments to Act — Factual record on two possible exceptions was incomplete — Monitor to investigate both scenarios — Claims procedure to be amended.

Bankruptcy and insolvency --- Companies' Creditors Arrangement Act — Miseellaneous

N Ltd. raised funds by issuing promissory notes bearing 12 percent annual return and issued preference shares with typical annual dividend of 10 percent — Funds were then lent out at much higher interest rates — N Ltd. sought protection of Companies' Creditors Arrangement Act — Preferred shareholders alleged, inter alia, theft, fraud, misrepresentation, breach of trust, excessive dividend payments, conversion of notes into preferred shares while N Ltd. was insolvent, oppression, and breach of fiduciary duties against N Ltd. — Promissory note holders brought motion to have all claims of preferred shareholders against N Ltd. classified as equity claims within meaning of Act; and requesting that unsecured creditors be entitled to be paid in full before preferred shareholders and other relief — Motion granted, subject to two possible exceptions — Claims of preferred shareholders fell within ambit of s. 2 of Act, were governed by ss. 6(8) and 22.1 of Act, and therefore did not constitute claims provable for purposes of statute — Preferred shareholders were not creditors of N Ltd. — Shares were treated as equity in N Ltd.'s financial statements and in its books and records — Substance of arrangement between preferred shareholders and N Ltd. was relationship based on equity, not debt — Pursuant to ss. 6(8) and 22.1, equity claims are rendered subordinate to those of creditors — Types of claims advanced by preferred shareholders were captured by language of reeent amendments to Act — Factual record on two possible exceptions was incomplete — Monitor to investigate both scenarios — Claims procedure to be amended.

Cases considered by *Pepall J.*:

Blue Range Resource Corp., Re (2000), 2000 CarswellAlta 12, 259 A.R. 30, 76 Alta. L.R. (3d) 338, [2000] 4 W.W.R. 738, 2000 ABQB 4, 15 C.B.R. (4th) 169 (Alta. Q.B.) — considered

Central Capital Corp., Re (1996), 132 D.L.R. (4th) 223, 27 O.R. (3d) 494, (sub nom. *Royal Bank v. Central Capital Corp.)* 88 O.A.C. 161, 1996 CarswellOnt 316, 38 C.B.R. (3d) 1, 26 B.L.R. (2d) 88 (Ont. C.A.) — followed

EarthFirst Canada Inc., Re (2009), 2009 ABQB 316, 2009 CarswellAlta 1069, 56 C.B.R. (5th) 102 (Alta. Q.B.) — considered

I. Waxman & Sons Ltd., Re (2008), 89 O.R. (3d) 427, 39 E.T.R. (3d) 49, 44 B.L.R. (4th) 295, 2008 CarswellOnt 1245, 40 C.B.R. (5th) 307, 64 C.C.E.L. (3d) 233 (Ont. S.C.J. [Commercial List]) — considered

Matter of Stirling Homex Corp. (1978), 579 F.2d 206 (U.S. 2nd Cir. N.Y.) — considered

National Bank of Canada v. Merit Energy Ltd. (2001), 2001 ABQB 583, 2001 CarswellAlta 913, 28 C.B.R. (4th) 228, [2001] 10 W.W.R. 305, 95 Alta. L.R. (3d) 166, 294 A.R. 15 (Alta. Q.B.) — considered

National Bank of Canada v. Merit Energy Ltd. (2002), 2002 ABCA 5, 2002 CarswellAlta 23, [2002] 3 W.W.R. 215, 96 Alta. L.R. (3d) 1, 299 A.R. 200, 266 W.A.C. 200 (Alta. C.A.) — referred to

Statutes considered:

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

s. 2 — considered

s. 2 "creditor" — considered

s. 121(1) — considered

Business Corporations Act, R.S.O. 1990, c. B.16

Generally — referred to

s. 23(3) — referred to

s. 248 — referred to

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

Generally — referred to

s. 2 — referred to

s. 2(1) "claim" — considered

s. 2(1) "equity claim" — considered

s. 2(1) "equity interest" — considered

s. 6(8) — considered

s. 22.1 [en. 2007, c. 36, s. 71] — considered

Securities Act, R.S.O. 1990, c. S.5

Generally — referred to

MOTION by promissory note holders to determine whether certain claims of preferred shareholders constitute equity claims for purposes of *Companies' Creditors Arrangement Act.*

***Pepall J.*:**

1 This motion addresses the legal characterization of claims of holders of preferred shares in the capital stock of the applicant, Nelson Financial Group Ltd. ("Nelson"). The issue before me is to determine whether such claims constitute equity claims for the purposes of sections 6(8) and 22.1 of the *Companies' Creditors Arrangement Act* ("*CCAA*").

Background Facts

2 Nelson was incorporated pursuant to the *Business Corporations Act* of Ontario in September, 1990. Nelson raised money from investors and then used those funds to extend credit to customers in vendor assisted financing programmes. It raised money in two ways. It issued promissory notes bearing a rate of return of 12% per annum and also issued preference shares typically with an annual dividend of 10%.[FN1] The funds were then lent out at significantly higher rates of interest.

3 The Monitor reported that Nelson placed ads in selected publications. The ads outlined the nature of the various investment options. Term sheets for the promissory notes or the preferred shares were then provided to the investors by Nelson together with an outline of the proposed tax treatment for the investment. No funds have been raised from investors since January 29, 2010.

(a) Noteholders

4 As of the date of the *CCAA* filing on March 23, 2010, Nelson had issued 685 promissory notes in the aggregate principal amount of $36,583,422.89. The notes are held by approximately 321 people.

(b) Preferred Shareholders

5 Nelson was authorized to issue two classes of common shares and 2,800,000 Series A preferred shares and 2,000,000 Series B preferred shares, each with a stated capital of $25.00. The president and sole director of Nelson, Marc Boutet, is the owner of all of the issued and outstanding common shares. By July 31, 2007, Nelson had issued to investors 176,675 Series A preferred shares for an aggregate consideration of $4,416,925. During the subsequent fiscal year ended July 31, 2008, Nelson issued a further 172,545 Series A preferred shares and 27,080 Series B preferred shares. These shares were issued for an aggregate consideration of $4,672,383 net of share issue costs.

6 The preferred shares are non-voting and take priority over the common shares. The company's articles of amendment provide that the preferred shareholders are entitled to receive fixed preferential cumulative cash dividends at the rate of 10% per annum. Nelson had the unilateral right to redeem the shares on payment of the purchase price plus accrued dividends. At least one investor negotiated a right of redemption. Two redemption requests were outstanding as of the *CCAA* filing date.

7 As of the *CCAA* filing date of March 23, 2010, Nelson had issued and outstanding 585,916.6 Series A and Series

B preferred shares with an aggregate stated capital of $14,647,914. The preferred shares are held by approximately 82 people. As of the date of filing of these *CCAA* proceedings, there were approximately $53,632 of declared but unpaid dividends outstanding with respect to the preferred shares and $73,652.51 of accumulated dividends.

8 Investors subscribing for preferred shares entered into subscription agreements described as term sheets. These were executed by the investor and by Nelson. Nelson issued share certificates to the investors and maintained a share register recording the name of each preferred shareholder and the number of shares held by each shareholder.

9 As reported by the Monitor, notwithstanding that Nelson issued two different series of preferred shares, the principal terms of the term sheets signed by the investors were almost identical and generally provided as follows:

- the issuer was Nelson;
- the par value was fixed at $25.00;
- the purpose was to finance Nelson's business operations;
- the dividend was 10% per annum, payable monthly, commencing one month after the investment was made;
- preferred shareholders were eligible for a dividend tax credit;
- Nelson issued annual T-3 slips on account of dividend income to the preferred shareholders;
- the preferred shares were non-voting (except where voting as a class was required), redeemable at the option of Nelson and ranked ahead of common shares; and
- dividends were cumulative and no dividends were to be paid on common shares if preferred share dividends were in arrears.

10 In addition, the Series B term sheet provided that the monthly dividend could be reinvested pursuant to a Dividend Reinvestment Plan ("DRIP").

11 The preferred shareholders were entered on the share register and received share certificates. They were treated as equity in the company's financial statements. Dividends were received by the preferred shareholders and they took the benefit of the advantageous tax treatment.

(c) Insolvency

12 Mr. Boutet knew that Nelson was insolvent since at least its financial year ended July 31, 2007. Nelson did not provide financial statements to any of the preferred shareholders prior to, or subsequent to, the making of the investment.

(d) Ontario Securities Commission

13 On May 12, 2010, the Ontario Securities Commission ("OSC") issued a Notice of Hearing and Statement of Allegations alleging that Nelson and its affiliate, Nelson Investment Group Ltd., and various officers and directors of those corporations committed breaches of the *Ontario Securities Act* in the course of selling preferred shares. The allegations include noncompliance with the prospectus requirements, the sale of shares in reliance upon exemptions that were inapplicable, the sale of shares to persons who were not accredited investors, and fraudulent and negligent

misrepresentations made in the course of the sale of shares. The OSC hearing has been scheduled for the end of February, 2011.

(e) Legal Opinion

14 Based on the Monitor's review, the preferred shareholders were documented as equity on Nelson's books and records and financial statements. Pursuant to court order, the Monitor retained Stikeman Elliott LLP as independent counsel to provide an opinion on the characterization of the claims and potential claims of the preferred shareholders. The opinion concluded that the claims were equity claims. The Monitor posted the opinion on its website and also advised the preferred shareholders of the opinion and conclusions by letter. The opinion was not to constitute evidence, issue estoppel or res judicata with respect to any matters of fact or law referred to therein. The opinion, at least in part, informed Nelson's position which was supported by the Monitor, that independent counsel for the preferred shareholders was unwarranted in the circumstances.

(f) Development of Plan

15 The Monitor reported in its Eighth Report that a plan is in the process of being developed and that preferred shareholders would have their existing preference shares cancelled and would then be able to claim a tax loss on their investment or be given a new form of preference shares with rights to be determined.

Motion

16 The holders of promissory notes are represented by Representative Counsel appointed pursuant to my order of June 15, 2010. Representative Counsel wishes to have some clarity as to the characterization of the preferred shareholders' claims. Accordingly, Representative Counsel has brought a motion for an order that all claims and potential claims of the preferred shareholders against Nelson be classified as equity claims within the meaning of the *CCAA*. In addition, Representative Counsel requests that the unsecured creditors, which include the noteholders, be entitled to be paid in full before any claim of a preferred shareholder and that the preferred shareholders form a separate class that is not entitled to vote at any meeting of creditors. Nelson and the Monitor support the position of Representative Counsel. The OSC is unopposed.

17 On the return of the motion, some preferred shareholders were represented by counsel from Templeman Menninga LLP and some were self-represented. It was agreed that the letters and affidavits of preferred shareholders that were filed with the court would constitute their evidence. Oral submissions were made by legal counsel and by approximately eight individuals. They had many complaints. Their allegations against Nelson and Mr. Boutet range from theft, fraud, misrepresentation including promises that their funds would be secured, operation of a Ponzi scheme, breach of trust, dividend payments to some that exceeded the rate set forth in Nelson's articles, conversion of notes into preferred shares at a time when Nelson was insolvent, non-disclosure, absence of a prospectus or offering memorandum disclosure, oppression, violation of section 23(3) of the *OBCA* and of the *Securities Act* such that the issuance of the preferred shares was a nullity, and breach of fiduciary duties.

18 The stories described by the investors are most unfortunate. Many are seniors and pensioners who have invested their savings with Nelson. Some investors had notes that were rolled over and replaced with preference shares. Mr. McVey alleges that he made an original promissory note investment which was then converted arbitrarily and without his knowledge into preference shares. He alleges that the documents effecting the conversion did not contain his authentic signature.

19 Mr. Styles states that he and his company invested approximately $4.5 million in Nelson. He states that Mr. Boutet persuaded him to convert his promissory notes into preference shares by promising a 13.75% dividend rate, assuring him that the obligation of Nelson to repay would be treated the same or better than the promissory notes, and

that they would have the same or a priority position to the promissory notes. He then received dividends at the 13.75% rate contrary to the 10% rate found in the company's articles. In addition, at the time of the conversion, Nelson was insolvent.

20 In brief, Mr. Styles submits that:

> (a) the investment transactions were void because there was no prospectus contrary to the provisions of the *Securities Act* and the Styles were not accredited investors; the preferred shares were issued contrary to section 23(3) of the *OBCA* in that Nelson was insolvent at the relevant time and as such, the issuance was a nullity; and the conduct of the company and its principal was oppressive contrary to section 248 of the *OBCA*; and that
>
> (b) the Styles' claim is in respect of an undisputed agreement relating to the conversion of their promissory notes into preferred shares which agreement is enforceable separate and apart from any claim relating to the preferred shares.

The Issue

21 Are any of the claims advanced by the preferred shareholders equity claims within section 2 of the *CCAA* such that they are to be placed in a separate class and are subordinated to the full recovery of all other creditors?

The Law

22 The relevant provisions of the *CCAA* are as follows.

Section 2 of the *CCAA* states:

> In this Act,
>
> "Claim" means any indebtedness, liability or obligation of any kind that would be a claim provable within the meaning of section 2 of the *Bankruptcy and Insolvency Act*;
>
> "Equity Claim" means a claim that is in respect of an equity interest, including a claim for, among others,
>
> (a) a dividend or similar payment,
>
> (b) a return of capital,
>
> (c) a redemption or retraction obligation,
>
> (d) a monetary loss resulting from the ownership, purchase or sale of an equity interest or from the rescission, or, in Quebec, the annulment, of a purchase or sale of an equity interest, or
>
> (e) contribution or indemnity in respect of a claim referred to in any of paragraphs (a) to (d);"
>
> "Equity Interest" means
>
> (a) in the case of a corporation other than an income trust, a share in the corporation — or a warrant or option

> or another right to acquire a share in the corporation — other than one that is derived from a convertible debt, and
>
> (b) in the case of an income trust, a unit in the income trust — or a warrant or option or another right to acquire a unit in the income trust — other than one that is derived from a convertible debt;

Section 6(8) states:

> No compromise or arrangement that provides for the payment of an equity claim is to be sanctioned by the court unless it provides that all claims that are not equity claims are to be paid in full before the equity claim is to be paid.

Section 22.1 states:

> Despite subsection 22(1) creditors having equity claims are to be in the same class of creditors in relation to those claims unless the court orders otherwise and may not, as members of that class, vote at any meeting unless the court orders otherwise.

23 Section 2 of the *Bankruptcy and Insolvency Act* ("*BIA*") which is referenced in section 2 of the *CCAA* provides that a claim provable includes any claim or liability provable in proceedings under the Act by a creditor. Creditor is then defined as a person having a claim provable as a claim under the Act.

24 Section 121(1) of the *BIA* describes claims provable. It states:

> 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 by reason of any obligation incurred before the day on which the bankrupt becomes bankrupt shall be deemed to be claims provable in proceedings under this Act.

25 Historically, the claims and rights of shareholders were not treated as provable claims and ranked after creditors of an insolvent corporation in a liquidation. As noted by Laskin J.A. in *Central Capital Corp., Re*[FN2], 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. This principle is premised on the notion that shareholders are understood to be higher risk participants who have chosen to tie their investment to the fortunes of the corporation. In contrast, creditors choose a lower level of exposure, the assumption being that they will rank ahead of shareholders in an insolvency. Put differently, amongst other things, equity investors bear the risk relating to the integrity and character of management.

26 This treatment also has been held to encompass fraudulent misrepresentation claims advanced by a shareholder seeking to recover his investment: *Blue Range Resource Corp., Re*[FN3] In that case, Romaine J. held that the alleged loss derived from and was inextricably intertwined with the shareholder interest. Similarly, in the United States, the Second Circuit Court of Appeal in *Matter of Stirling Homex Corp.*[FN4] concluded that shareholders, including those who had allegedly been defrauded, were subordinate to the general creditors when the company was insolvent. The Court stated that "the real party against which [the shareholders] are seeking relief is the body of general creditors of their corporation. Whatever relief may be granted to them in this case will reduce the percentage which the general creditors will ultimately realize upon their claims." *National Bank of Canada v. Merit Energy Ltd.*[FN5] and *Earth-First Canada Inc., Re*[FN6] both treated claims relating to agreements that were collateral to equity claims as equity claims. These cases dealt with separate indemnification agreements and the issuance of flow through shares. The separate agreements and the ensuing claims were treated as part of one integrated transaction in respect of an equity interest. The case law has also recognized the complications and delay that would ensue if *CCAA* proceedings were mired in shareholder claims.

27 The amendments to the *CCAA* came into force on September 18, 2009. It is clear that the amendments incorporated the historical treatment of equity claims. The language of section 2 is clear and broad. Equity claim means a claim in respect of an equity interest and includes, amongst other things, a claim for rescission of a purchase or sale of an equity interest. Pursuant to sections 6(8) and 22.1, equity claims are rendered subordinate to those of creditors.

28 The Nelson filing took place after the amendments and therefore the new provisions apply to this case. Therefore, if the claims of the preferred shareholders are properly characterized as equity claims, the relief requested by Representative Counsel in his notice of motion should be granted.

29 Guidance on the appropriate approach to the issue of characterization was provided by the Ontario Court of Appeal in *Central Capital Corp., Re*[FN7]. Central Capital was insolvent and sought protection pursuant to the provisions of the *CCAA*. The appellants held preferred shares of Central Capital. The shares each contained a right of retraction, that is, a right to require Central Capital to redeem the shares on a fixed date and for a fixed price. One shareholder exercised his right of retraction and the other shareholder did not but both filed proofs of claim in the *CCAA* proceedings. In considering whether the two shareholders had provable debt claims, Laskin J.A. considered the substance of the relationship between the company and the shareholders. If the governing instrument contained features of both debt and equity, that is, it was hybrid in character, the court must determine the substance of the relationship between the company and the holder of the certificate. The Court examined the parties' intentions.

30 In *Central Capital*, Laskin J.A. looked to the share purchase agreements, the conditions attaching to the shares, the articles of incorporation and the treatment given to the shares in the company's financial statements to ascertain the parties' intentions and determined that the claims were equity and not debt claims.

31 In this ease, there are characteristics that are suggestive of a debt claim and of an equity claim. That said, in my view, the preferred shareholders are, as their description implies, shareholders of Nelson and not ereditors. In this regard, I note the following.

(a) Investors were given the option of investing in promissory notes or preference shares and opted to invest in shares. Had they taken promissory notes, they obviously would have been ereditors. The preference shares carried many attractions including income tax advantages.

(b) The investors had the right to receive dividends, a well recognized right of a shareholder.

(c) The preference share conditions provided that on a liquidation, dissolution or winding up, the preferred shareholders ranked ahead of common shareholders. As in *Central Capital Corp.*, it is implicit that they therefore would rank behind creditors.

(d) Although I aeknowledge that the preferred shareholders did not receive copies of the financial statements, nonetheless, the shares were treated as equity in Nelson's financial statements and in its books and records.

32 The substance of the arrangement between the preferred shareholders and Nelson was a relationship based on equity and not debt. Having said that, as I observed in *I. Waxman & Sons Ltd., Re*[FN8], there is support in the case law for the proposition that equity may become debt. For instance, in that case, I held that a judgment obtained at the suit of a shareholder constituted debt. An analysis of the nature of the elaims is therefore required. If the claims fall within the parameters of section 2 of the *CCAA*, clearly they are to be treated as equity claims and not as debt claims.

33 In this case, in essence the claims of the preferred shareholders are for one or a combination of the following:

(a) declared but unpaid dividends;

(b) unperformed requests for redemption;

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

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

34 In my view, all of these claims fall within the ambit of section 2, are governed by sections 6(8) and 22.1 of the *CCAA*, and therefore do not constitute a claim provable for the purposes of the statute. The language of section 2 is clear and unambiguous and equity claims include "a claim that is in respect of an equity interest" and a claim for a dividend or similar payment and a claim for rescission. This encompasses the claims of all of the preferred shareholders including the Styles whose claim largely amounts to a request for rescission or is in respect of an equity interest. The case of *National Bank of Canada v Merit Energy Ltd.*[FN9] is applicable in regard to the latter. In substance, the Styles' claim is for an equity obligation. At a minimum, it is a claim in respect of an equity interest as described in section 2 of the CCAA. Parliament's intention is clear and the types of claims advanced in this case by the preferred shareholders are captured by the language of the amended statute. While some, and most notably Professor Janis Sarra[FN10], advocated a statutory amendment that provided for some judicial flexibility in cases involving damages arising from egregious conduct on the part of a debtor corporation and its officers, Parliament opted not to include such a provision. Sections 6(8) and 22.1 allow for little if any flexibility. That said, they do provide for greater certainty in the appropriate treatment to be accorded equity claims.

35 There are two possible exceptions. Mr. McVey claims that his promissory note should never have been converted into preference shares, the conversion was unauthorized and that the signatures on the term sheets are not his own. If Mr. McVey's evidence is accepted, his claim would be qua creditor and not preferred shareholder. Secondly, it is possible that monthly dividends that may have been lent to Nelson by Larry Debono constitute debt claims. The factual record on these two possible exceptions is incomplete. The Monitor is to investigate both scenarios, consider a resolution of same, and report back to the court on notice to any affected parties.

36 Additionally, the claims procedure will have to be amended. The Monitor should consider an appropriate approach and make a recommendation to the court to accommodate the needs of the stakeholders. The relief requested in the notice of motion is therefore granted subject to the two aforesaid possible exceptions.

Motion granted.

FN1 The Monitor is aware of six preferred shareholders with dividends that ranged from 10.5% to 13.75% per annum.

FN2 (1996), 38 C.B.R. (3d) 1 (Ont. C.A.).

FN3 (2000), 15 C.B.R. (4th) 169 (Alta. Q.B.).

FN4 (1978), 579 F.2d 206 (U.S. 2nd Cir. N.Y.).

FN5 2001 CarswellAlta 913 (Alta. Q.B.), aff'd 2002 CarswellAlta 23 (Alta. C.A.).

FN6 2009 CarswellAlta 1069 (Alta. Q.B.).

FN7 Supra, note 2.

FN8 2008 CarswellOnt 1245 (Ont. S.C.J. [Commercial List]).

FN9 Supra, note 5.

FN10 "From Subordination to Parity: An International Comparison of Equity Securities Law Claims in Insolvency Proceedings" (2007) 16 Int. Insolv. Re., 181.

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Tab 4

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National Bank of Canada v. Merit Energy Ltd.

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.

Alberta Court of Queen's Bench

LoVecchio J.

Heard: April 30, 2001
Judgment: July 3, 2001[FN*]
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

2001 CarswellAlta 913, 2001 ABQB 583, [2001] A.W.L.D. 539, [2001] 10 W.W.R. 305, 28 C.B.R. (4th) 228, 95 Alta. L.R. (3d) 166, 294 A.R. 15, 107 A.C.W.S. (3d) 182

Bankruptcy --- Priorities of claims — Unsecured claims — Priority with respect to other unsecured creditors

Underwriters participated in distribution of several flow-through shares of company, marketed on strength of exploration company's tax benefits — Company's accumulated expenses and tax benefits were far below amounts projected — Company became insolvent and entered receivership — Company's shareholders brought several actions against company, company's directors, officers and auditor, alleging misrepresentations in prospectus — Underwriters, directors and officers of exploration company were denied status as equitable lien holders — Trustee brought application for determination of status of shareholders, directors, owners, and auditor and underwriters as creditors of company — Directors, officers, auditor and underwriters were unsecured creditors of company — Flow-through shareholders were not creditors company — Substance of shareholders' claims was for return of invested equity — Fact that shareholders' claims were not made in tort did not change substance of claims — Fact that some aspects of share transaction resembled debtor creditor relationship did not change shareholders to creditors — Substance of underwriters' claim was for relief based on contractual, legal and equitable duties and not return of investment — Underwriters' claim was not too contingent, as was not too remote or speculative in nature — Underwriters' claim for costs and disbursements incurred defending shareholders' claims was not contingent and was independent grounds for claim.

Bankruptcy --- Priorities of claims — Restricted and postponed claims — Officers, directors, and stockholders

Underwriters participated in distribution of several flow-through shares of company, marketed on strength of exploration company's tax benefits — Company's accumulated expenses and tax benefits were far below amounts projected — Company became insolvent and entered receivership — Company's shareholders brought several actions against company, company's directors, officers and auditor, alleging misrepresentations in prospectus — Directors and officers of exploration company were denied status as equitable lien holders — Trustee brought application for determination of status of shareholders, directors, owners — Directors and officers were unsecured creditors of company — Flow-through shareholders were not creditors company — Substance of shareholders' claims was for return of invested equity — Fact that shareholders' claims were not made in tort did not change substance of claims — Fact that some aspects of share transaction resembled debtor creditor relationship did not change shareholders to creditors.

Cases considered by *LoVecchio J.*:

Blue Range Resource Corp., Re, 2000 CarswellAlta 12, 76 Alta. L.R. (3d) 338, [2000] 4 W.W.R. 738, 15 C.B.R. (4th) 169, 259 A.R. 30 (Alta. Q.B.) — considered

Canada Deposit Insurance Corp. v. Canadian Commercial Bank, 5 Alta. L.R. (3d) 193, [1992] 3 S.C.R. 558, 16 C.B.R. (3d) 154, 7 B.L.R. (2d) 113, (sub nom. *Canada Deposit Insurance Corp. v. Canadian Commercial Bank (No. 3))* 131 A.R. 321, (sub nom. *Canada Deposit Insurance Corp. v. Canadian Commercial Bank (No. 3))* 25 W.A.C. 321, 97 D.L.R. (4th) 385, (sub nom. *Canada Deposit Insurance Corp. v. Canadian Commercial Bank (No. 3))* 143 N.R. 321 (S.C.C.) — considered

Canadian Triton International Ltd., Re (1997), 49 C.B.R. (3d) 192 (Ont. Bktcy.) — referred to

Central Capital Corp., Re (1996), 38 C.B.R. (3d) 1, 26 B.L.R. (2d) 88, 132 D.L.R. (4th) 223, 27 O.R. (3d) 494, (sub nom. *Royal Bank v. Central Capital Corp.)* 88 O.A.C. 161 (Ont. C.A.) — considered

Claude Resources Inc. (Trustee of) v. Dutton (1993), 22 C.B.R. (3d) 56, (sub nom. *Claude Resources Inc. (Bankrupt), Re)* 115 Sask. R. 35 (Sask. Q.B.) — considered

Confederation Treasury Services Ltd., Re, 43 C.B.R. (3d) 4, (sub nom. *Confederation Treasury Services Ltd.*

2001 CarswellAlta 913, 2001 ABQB 583, [2001] A.W.L.D. 539, [2001] 10 W.W.R. 305, 28 C.B.R. (4th) 228, 95 Alta. L.R. (3d) 166, 294 A.R. 15, 107 A.C.W.S. (3d) 182

(Bankrupt), Re) 96 O.A.C. 75 (Ont. C.A.) — considered

Froment, Re, [1925] 2 W.W.R. 415 (Alta. T.D.) — referred to

G.M.D. Vending Co., Re (1994), 94 B.C.L.R. (2d) 130, (sub nom. *G.M.D. Vending Co. (Bankrupt), Re)* 45 B.C.A.C. 231, 27 C.B.R. (3d) 77, (sub nom. *G.M.D. Vending Co. (Bankrupt), Re)* 72 W.A.C. 231 (B.C. C.A.) — considered

Gardner v. Newton (1916), 10 W.W.R. 51, 26 Man. R. 251, 29 D.L.R. 276 (Man. K.B.) — considered

Magellan Aerospace Ltd. v. First Energy Capital Corp., 2001 ABCA 138 (Alta. C.A.) — referred to

Negus v. Oakley's General Contracting (1996), 152 N.S.R. (2d) 172, 442 A.P.R. 172, 40 C.B.R. (3d) 270 (N.S. S.C.) — considered

Ontario (Securities Commission) v. Consortium Construction Inc. (1993), 1 C.C.L.S. 117 (Ont. Gen. Div. [Commercial List]) — referred to

United States v. Noland (1996), 517 U.S. 535, 116 S. Ct. 1524, 134 L. Ed. 2d 748, 64 U.S.L.W. 4328, 77 A.F.T.R.2d 96-2143 (U.S. Ohio) — considered

Wiebe, Re (1995), 30 C.B.R. (3d) 109 (Ont. Bktcy.) — referred to

Statutes considered:

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

Generally — referred to

s. 121(1) [rep. & sub. 1992, c. 27, s. 50(1)] — considered

s. 121(2) [rep. & sub. 1997, c. 12, s. 87(1)] — considered

s. 135(1.1) [en. 1997, c. 12, s. 89(1)] — considered

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

Generally — referred to

Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.)

Generally — referred to

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

LoVecchio J.:

2001 CarswellAlta 913, 2001 ABQB 583, [2001] A.W.L.D. 539, [2001] 10 W.W.R. 305, 28 C.B.R. (4th) 228, 95 Alta. L.R. (3d) 166, 294 A.R. 15, 107 A.C.W.S. (3d) 182

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[FN1], 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.*[FN2], 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*.[FN3]

9 The Flow-Through Shareholders, the Underwriters and the Directors and Officers[FN4] 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 liabil-

ities, 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.

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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 indemnifieation will not operate where PriceWaterhouseCoopers ought to have uncovered such knowing misrepresentation but failed to, due the gross negligence or willful misconduct of PriceWaterhouse-Coopers, 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

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The claims of the Flow-Through Shareholders are subordinate to the claims of Merit's unsecured creditors as they are in substanee 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. eompleted 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;

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(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*[FN5] 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. Iacobueci J. stated at p. 406:

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

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

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

i. The Trustee's Position

31 The Trustee (through counsel) focussed on the allegations made in the statements of claim in its analysis. It

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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* [FN6] 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*[FN7] 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,[FN8] 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[FN9]. He further submitted that the fact they are claims by shareholders is irrelevant.

41 He relied on *Gardner v. Newton* [FN10] 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*[FN11] departed from the earlier cases relied upon by the Trustee, including*Claude Resources Inc. (Trustee of) v. Dutton*[FN12]. 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

2001 CarswellAlta 913, 2001 ABQB 583, [2001] A.W.L.D. 539, [2001] 10 W.W.R. 305, 28 C.B.R. (4th) 228, 95 Alta. L.R. (3d) 166, 294 A.R. 15, 107 A.C.W.S. (3d) 182

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 I

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[FN13], 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[FN14]. In essence, what happens in a flow- through share offering (as sanctioned by the *Income Tax Act*[FN15]) 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)

2001 CarswellAlta 913, 2001 ABQB 583, [2001] A.W.L.D. 539, [2001] 10 W.W.R. 305, 28 C.B.R. (4th) 228, 95 Alta. L.R. (3d) 166, 294 A.R. 15, 107 A.C.W.S. (3d) 182

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 ereditors 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

2001 CarswellAlta 913, 2001 ABQB 583, [2001] A.W.L.D. 539, [2001] 10 W.W.R. 305, 28 C.B.R. (4th) 228, 95 Alta. L.R. (3d) 166, 294 A.R. 15, 107 A.C.W.S. (3d) 182

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 faet 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*[FN16] :

> [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.

2001 CarswellAlta 913, 2001 ABQB 583, [2001] A.W.L.D. 539, [2001] 10 W.W.R. 305, 28 C.B.R. (4th) 228, 95 Alta. L.R. (3d) 166, 294 A.R. 15, 107 A.C.W.S. (3d) 182

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.[FN17]

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"[FN18]. Provable claims include contingent claims as long as they are not too speculative: *Negus v. Oakley's General Contracting*[FN19] . Section 121 defines provable claims to include "all debts and liabilities, present or future,...to which the bankrupt may become subject...".

77 Section 121 does not specify the degree of certainty required to make a claim provable, other than to include as provable all debts or liabilities to which the bankrupt may become subject. As stated, the Ontario Court of Appeal addressed this in *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.[FN20] 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*.

2001 CarswellAlta 913, 2001 ABQB 583, [2001] A.W.L.D. 539, [2001] 10 W.W.R. 305, 28 C.B.R. (4th) 228, 95 Alta. L.R. (3d) 166, 294 A.R. 15, 107 A.C.W.S. (3d) 182

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.

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.

Order accordingly.

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

FN1 Reasons followed the dismissal from the bench 2001 ABCA 138 (Alta. C.A.).

FN2 (2000), 15 C.B.R.(4th) 169 (Alta. Q.B.).

FN3 R.S.C.1985, c.B-3

FN4 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.

FN5 (1992), 97 D.L.R. (4th) 385 (S.C.C.)

FN6 (1996), 27 O.R. (3d) 494 (Ont. C.A.)

FN7 (1994), 94 B.C.L.R. (2d) 130 (B.C. C.A.)

FN8 See *Ontario (Securities Commission) v. Consortium Construction Inc.* (1993), 1 C.C.L.S. 117 (Ont. Gen. Div. [Commercial List]), at 138-139.

FN9 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.

2001 CarswellAlta 913, 2001 ABQB 583, [2001] A.W.L.D. 539, [2001] 10 W.W.R. 305, 28 C.B.R. (4th) 228, 95 Alta. L.R. (3d) 166, 294 A.R. 15, 107 A.C.W.S. (3d) 182

FN10 (1916), 29 D.L.R. 276 (Man. K.B.)

FN11 (1997), 43 C.B.R. (3d) 4 (Ont. C.A.).

FN12 (1993), 22 C.B.R. (3d) 56 (Sask. Q.B.), referred to favourably by Farley J. in *Canadian Triton Interational 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.)

FN13 Counsel described the claims variously as "statutory", "statutory/tort and "contractual"

FN14 V.M. Jog et al, "Flow Through Shares: Premium-Sharing and Trust-Effectiveness", (1996), 44 Can. Tax J. at p. 1017.

FN15 R.S.C. 1985, (5th Supp.),c. 1.

FN16 517 U.S. 535 (U.S. Ohio, 1996), at 539.

FN17 *Supra* footnote 9 for *BIA* definitions in ss. 121 and 135

FN18 *ibid.*

FN19 (1996), 40 C.B.R. (3d) 270 (N.S. S.C.)

FN20 See for example, *Froment, Re*, [1925] 2 W.W.R. 415 (Alta. T.D.)

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Tab 5

2009 CarswellAlta 1069, 2009 ABQB 316, [2009] A.W.L.D. 3179, [2009] A.W.L.D. 3180, 56 C.B.R. (5th) 102

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2009 CarswellAlta 1069, 2009 ABQB 316, [2009] A.W.L.D. 3179, [2009] A.W.L.D. 3180, 56 C.B.R. (5th) 102

EarthFirst Canada Inc., Re

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

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

Alberta Court of Queen's Bench

B.E. Romaine J.

Heard: May 13, 2009
Judgment: May 27, 2009[FN*]
Docket: Calgary 0801-13559

Counsel: Kelly J. Bourassa, Scott Kurie for Indemnity Claimants of EarthFirst Canada Inc.

Howard A. Gorman for EarthFirst Canada Inc.

A. Robert Anderson, Q.C., Eric D. Stearns for Monitor, Ernst & Young Inc.

Subject: Insolvency

Bankruptcy and insolvency --- Proposal — Companies' Creditors Arrangement Act — Miscellaneous issues

Company issued flow-throw common shares — Under subscription agreement for shares, company made covenant to renounce to subscriber qualifying expenditures under ss. 66(12.6) and 66(12.66) of Income Tax Act, or indemnify subscriber for tax payable as consequence of failure to renounce — Company brought application for declaration as to proper characterization of claims under indemnity for purpose of proposed plan of arrangement under Companies' Creditors Arrangement Act — Potential claims were in substance equity obligations rather than debt or creditor obligations — Claims ranked behind claims made by creditors of company and would not participate in any creditor plan or distribution — Issue was determined by finding of Court of Appeal in prior case that debt features associated with indemnity did not transform that part of relationship from shareholder relationship into debt relationship.

Bankruptcy and insolvency --- Proving claim — Provable debts — Claims of director, officer or shareholder of bankrupt corporation

Company issued flow-throw common shares — Under subscription agreement for shares, company made covenant to renounce to subscriber qualifying expenditures under ss. 66(12.6) and 66(12.66) of Income Tax Act, or indemnify

subscriber for tax payable as consequence of failure to renounce — Company brought application for declaration as to proper characterization of claims under indemnity for purpose of proposed plan of arrangement under Companies' Creditors Arrangement Act — Potential claims were in substance equity obligations rather than debt or creditor obligations — Claims ranked behind claims made by creditors of company and would not participate in any creditor plan or distribution — Issue was determined by finding of Court of Appeal in prior case that debt features associated with indemnity did not transform that part of relationship from shareholder relationship into debt relationship.

Cases considered by *B.E. Romaine J.*:

Canada Deposit Insurance Corp. v. Canadian Commercial Bank (1992), 5 Alta. L.R. (3d) 193, [1992] 3 S.C.R. 558, 16 C.B.R. (3d) 154, 7 B.L.R. (2d) 113, (sub nom. *Canada Deposit Insurance Corp. v. Canadian Commercial Bank (No. 3)*) 131 A.R. 321, (sub nom. *Canada Deposit Insurance Corp. v. Canadian Commercial Bank (No. 3)*) 25 W.A.C. 321, 1992 CarswellAlta 790, 97 D.L.R. (4th) 385, (sub nom. *Canada Deposit Insurance Corp. v. Canadian Commercial Bank (No. 3)*) 143 N.R. 321, 1992 CarswellAlta 298 (S.C.C.) — referred to

I. Waxman & Sons Ltd., Re (2008), 89 O.R. (3d) 427, 39 E.T.R. (3d) 49, 44 B.L.R. (4th) 295, 2008 CarswellOnt 1245, 40 C.B.R. (5th) 307, 64 C.C.E.L. (3d) 233 (Ont. S.C.J. [Commercial List]) — referred to

National Bank of Canada v. Merit Energy Ltd. (2001), 2001 ABQB 583, 2001 CarswellAlta 913, 28 C.B.R. (4th) 228, [2001] 10 W.W.R. 305, 95 Alta. L.R. (3d) 166, 294 A.R. 15 (Alta. Q.B.) — followed

National Bank of Canada v. Merit Energy Ltd. (2002), 2002 ABCA 5, 2002 CarswellAlta 23, [2002] 3 W.W.R. 215, 96 Alta. L.R. (3d) 1, 299 A.R. 200, 266 W.A.C. 200 (Alta. C.A.) — considered

Statutes considered:

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

s. 140.1 [en. 2005, c. 47, s. 90; rep. & sub. 2007, c. 36, s. 49] — considered

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

Generally — referred to

Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.)

Generally — referred to

APPLICATION for declaration as to proper characterization of flow-through shares for purpose of proposed plan of arrangement under *Companies' Creditors Arrangement Act*.

***B.E. Romaine J.*:**

Introduction

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

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

Facts

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

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

3 Certain conditions were required to be satisfied before expenditures made by Earthfirst would qualify as "Qualifying Expenditures" pursuant to the *Income Tax Act* and the associated regulations. Because construction of Earthfirst's Dokie 1 wind power project was interrupted by events triggered by the CCAA filing, it may be that Earthfirst will not be able to satisfy some of these conditions. While Earthfirst is seeking a purchaser of the Dokie 1 project assets, and that purchaser may complete the necessary requirements for expenditures to be considered "Qualifying Expenditures", there is presently no guarantee that the necessary conditions will be met. The subscribers for flow-through shares may therefore have a claim under the indemnity set out in the subscription agreement.

Issue

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

Analysis

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

> (a) that the underlying rights that form the basis of the claims are severable and distinct from the status of

> subscribers as shareholders of Earthfirst, in that the flow-through shares are composed of two distinct components, being common shares and the subscriber's right to the renunciation of a certain amount of tax credit or the right to be indemnified for tax credit not so renounced. It is submitted that further evidence of the distinct and severable nature of the indemnity claim can be found in the fact that, while the common share component of the flow-through shares can be transferred, the flow-through benefits accrue only to original subscribers;
>
> (b) that the claimants in advancing a claim under the indemnity are not advancing a claim for the return of their investment in common shares;
>
> (c) that the rights and obligations that form the basis of the indemnity claim are set out in the subscription agreement, which indicates an intention to create a debt obligation in the indemnity provisions; and
>
> (d) that the claim under the indemnity is limited to a specific amount as compared to the unlimited upside potential of any equity investment, and that thus one of the policy reasons for drawing a distinction between debt and equity in the context of insolvency does not apply to an indemnity claim.

[4] On the other side of the argument, it is clear that the indemnity claim derives from the original status of the subscribers as subscribers of shares, that the claim was acquired as part of an investment in shares, and that any recovery on the indemnity would serve to recoup a portion of what the subscriber originally invested, primarily qua shareholder. While it may be true that equity may become debt, as, for instance, in the case of declared dividends or a claim reduced to a judgment debt (*I. Waxman & Sons Ltd., Re*, [2008] O.J. No. 885 (Ont. S.C.J. [Commercial List]) at para 24 and 25), the indemnity claim has not undergone a transformation from its original purpose as a "sweetener" to the offering of common shares, even if individual subscribers have since sold the shares to which it was attached. The renunciation of flow-through tax credits, despite the payment of a premium for this feature, can be characterized as incidental or secondary to the equity features of the investment, a marketing feature that provided an alternative to the share plus warrant tranche of the public offering for investors who found the feature attractive: *Canada Deposit Insurance Corp. v. Canadian Commercial Bank*, [1992] S.C.J. No. 96 (S.C.C.) at para. 54.

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

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

The Court of Appeal in dismissing the appeal commented:

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

The decision in Merit Energy thus determines the issue in this case, which is not distinguishable on any basis that is relevant to the issue. I also note that, while it is not determinative of the issue as the legislation has not yet been pro-

claimed, section 49 of Bill C-12, *An Act to amend the Bankruptcy and Insolvency Act*, the *Companies' Creditors Act*, the *Wage Protection Program Act* and Chapter 47 of the *Statues of Canada*, 2005, 2nd Sess., 39th Parl., 2007, ss. 49, 71 [Statute c.36] provides that a creditor is not entitled to a dividend in respect of any equity claim until all other claims are satisfied. Equity Claims are defined as including:

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

Conclusion

I therefore grant:

> a) a declaration that potential claims that holders of flow-through common shares in Earthfirst may have against Earthfirst, if any, are at their core equity obligations rather than debt or creditor obligations, and, as such, necessarily rank behind in priority to claims made by creditors of Earthfirst and will not participate in any creditor plan or distribution; and
>
> b) an order permitting Earthfirst to make certain payment to its creditors pursuant to a Plan of Arrangement in an amount and upon such terms to be determined by this Honourable Court at the date of this application without regard to any contingent or other claims of the flow-through shareholders or subscribers.

Order accordingly.

FN* A corrigendum issued by the court on July 8, 2009 has been incorporated herein.

END OF DOCUMENT

Tab 6

DEBTORS AND CREDITORS SHARING THE BURDEN:

A Review of the *Bankruptcy and Insolvency Act* and the *Companies' Creditors Arrangement Act*

Report of the Standing Senate
Committee on Banking, Trade and Commerce

Chair
The Honourable Richard H. Kroft

Deputy Chair
The Honourable David Tkachuk

November 2003

5. Subordination of Equity Claims

Insolvency legislation in the United States has created the concept of "subordination of equity claims." Equity claims are those claims that are not based on the supply of goods, services or credit to a corporation, but rather are based on some wrongful or allegedly wrongful act committed by the issuer of an instrument reflecting equity in the capital of a corporation. Conceptually, this type of claim relates more to the loss of a claimant who holds shares or other equity instruments issued by a corporation, rather than the claims of traditional suppliers. In American legislation, such claims are subordinated to the claims of traditional suppliers.

Canadian insolvency law does not subordinate shareholder or equity damage claims.

Canadian insolvency law does not subordinate shareholder or equity damage claims. It is thought that this treatment has led some Canadian companies to reorganize in the United States rather than in Canada.

Mr. Kent, for example, told the Committee that "[i]f [a shareholders' rights claims by people who say that they have been lied to through the public markets] is filed in Canada, there is no facility in place to deal with it. They have no choice but to file in the U.S. where there is a vehicle to deal with these claims in a sensible, fair and reasonable way. In Canada, we have no mechanism. Thus, you end up with situations where it becomes difficult to reorganize a Canadian enterprise under Canadian law because our laws do not generally deal with shareholder claims."

He also indicated, however, that shareholder claims may be addressed within specific corporate statutes. Mr. Kent mentioned, in particular, the *Canada Business Corporations Act* and some provincial/territorial statutes, and shared his view that "[i]t becomes a lottery, depending on where the corporation is organized, whether there is a vehicle for dealing with some of these claims or there may not be. It is a hodgepodge system."

The Joint Task Force on Business Insolvency Law Reform shared with the Committee a proposal that all claims arising under or relating to an instrument that is in the form of equity are to be treated as equity claims. Consequently, "all [equity] claims against a debtor in an insolvency proceeding ... including claims for payment of dividends, redemption or retraction or repurchase or shares, and damages (including securities fraud claims) are to be treated as equity claims subordinate to all other secured and unsecured claims against the debtor ... ." It also proposed that these claims could be extinguished, at the discretion of the Court, in connection with the approval of a reorganization plan.

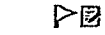
In view of recent corporate scandals in North America, the Committee believes that the issue of equity claims must be addressed in insolvency legislation. In our view, the law must recognize the facts in insolvency proceedings: since holders of equity have necessarily accepted – through their acceptance of equity rather than debt – that their claims will have a lower priority than claims for debt, they must step aside in a bankruptcy proceeding. Consequently, their claims should be afforded lower ranking than secured and unsecured creditors, and the law – in the interests of fairness and predictability – should reflect both this lower priority for holders of equity and the notion that they will not participate in a restructuring or recover anything until all other creditors have been paid in full. From this perspective, the Committee recommends that:

In view of recent corporate scandals in North America, the Committee believes that the issue of equity claims must be addressed in insolvency legislation.

The *Bankruptcy and Insolvency Act* be amended to provide that the claim of a seller or purchaser of equity securities, seeking damages or rescission in connection with the transaction, be subordinated to the claims of ordinary creditors. Moreover, these claims should not participate in the proceeds of a restructuring or bankruptcy until other creditors of the debtor have been paid in full.

Tab 7

1998 CarswellOnt 1, 154 D.L.R. (4th) 193, 36 O.R. (3d) 418 (headnote only), (sub nom. Rizzo & Rizzo Shoes Ltd. (Bankrupt), Re) 221 N.R. 241, (sub nom. Adrien v. Ontario Ministry of Labour) 98 C.L.L.C. 210-006, 50 C.B.R. (3d) 163, (sub nom. Rizzo & Rizzo Shoes Ltd. (Bankrupt), Re) 106 O.A.C. 1, [1998] 1 S.C.R. 27, 33 C.C.E.L. (2d) 173, 1998 CarswellOnt 2, [1998] 1 S.C.R. 27, [1998] S.C.J. No. 2



1998 CarswellOnt 1, 154 D.L.R. (4th) 193, 36 O.R. (3d) 418 (headnote only), (sub nom. Rizzo & Rizzo Shoes Ltd. (Bankrupt), Re) 221 N.R. 241, (sub nom. Adrien v. Ontario Ministry of Labour) 98 C.L.L.C. 210-006, 50 C.B.R. (3d) 163, (sub nom. Rizzo & Rizzo Shoes Ltd. (Bankrupt), Re) 106 O.A.C. 1, [1998] 1 S.C.R. 27, 33 C.C.E.L. (2d) 173, 1998 CarswellOnt 2, [1998] 1 S.C.R. 27, [1998] S.C.J. No. 2

Rizzo & Rizzo Shoes Ltd., Re

Philippe Adrien, Emilia Berardi, Paul Creador, Lorenzo Abel Vasquez and Lindy Wagner on their own behalf and on behalf of the other former employees of Rizzo & Rizzo Shoes Limited, Appellants v. Zittrer, Siblin & Associates, Inc., Trustees in Bankruptcy of the Estate of Rizzo & Rizzo Shoes Limited, Respondent and The Ministry of Labour for the Province of Ontario, Employment Standards Branch, Party

Supreme Court of Canada

Gonthier, Cory, McLachlin, Iacobucci, Major JJ.

Heard: October 16, 1997
Judgment: January 22, 1998
Docket: 24711

Proceedings: reversing (1995), 30 C.B.R. (3d) 1 (C.A.); reversing (1991), 11 C.B.R. (3d) 246 (Ont. Gen. Div.)

Counsel: *Steven M. Barrett* and *Kathleen Martin*, for the appellants.

Raymond M. Slattery, for the respondent.

David Vickers, for the Ministry of Labour for the Province of Ontario, Employment Standards Branch.

Subject: Labour and Employment; Insolvency

Bankruptcy --- Priorities of claims — Preferred claims — Wages and salaries of employees — Type of wages claimable

Trustee in bankruptcy closed bankruptcy employer's stores and paid employees all outstanding wages, commissions and vacation pay up to termination date — Ministry of Labour determined that employees were owed termination and severance pay, and filed claim with trustee which trustee disallowed — Court of Appeal ultimately upheld trustee's disallowance — Employees appealed — Appeal allowed — Termination resulting from bankruptcy gave rise to unsecured provable claim for termination and severance pay — Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3, s. 121 — Employment Standards Act, R.S.O. 1980, c. 137, ss. 40(1), 40(7), 40a — Employment Standards Amendment Act, 1981, S.O. 1981, c. 22, s. 2(3) — Interpretation Act, R.S.O. 1990, c. I.11, s. 10.

1998 CarswellOnt 1, 154 D.L.R. (4th) 193, 36 O.R. (3d) 418 (headnote only), (sub nom. Rizzo & Rizzo Shoes Ltd. (Bankrupt), Re) 221 N.R. 241, (sub nom. Adrien v. Ontario Ministry of Labour) 98 C.L.L.C. 210-006, 50 C.B.R. (3d) 163, (sub nom. Rizzo & Rizzo Shoes Ltd. (Bankrupt), Re) 106 O.A.C. 1, [1998] 1 S.C.R. 27, 33 C.C.E.L. (2d) 173, 1998 CarswellOnt 2, [1998] 1 S.C.R. 27, [1998] S.C.J. No. 2

Employment law — Termination and dismissal — Termination of employment by employer — Severance pay under employment standards legislation

Trustee in bankruptcy closed bankruptcy employer's stores and paid employees all outstanding wages, commissions and vacation pay up to termination date — Ministry of Labour determined that employees were owed termination and severance pay, and filed claim with trustee which trustee disallowed — Court of Appeal ultimately upheld trustee's disallowance — Employees appealed — Appeal allowed — Termination resulting from bankruptcy gave rise to unsecured provable claim for termination and severance pay — Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3, s. 121 — Employment Standards Act, R.S.O. 1980, c. 137, ss. 40 (1), 40(7), 40a — Employment Standards Amendment Act, 1981, S.O. 1981, c. 22, s. 2(3) — Interpretation Act, R.S.O. 1990, c. I.11, s. 10.

Faillite — Priorité des créances — Créances prioritaires — Traitements et salaires des employés — Types de traitements exigibles

Syndic a procédé à la fermeture des magasins du failli et a payé tous les traitements, commissions et paies de vacances dus aux employés jusqu'à la date de cessation d'emploi — Ministère du travail a déterminé que les employés avaient droit à une indemnité de cessation d'emploi et a présenté une preuve de réclamation au syndic, lequel a rejeté la preuve de réclamation — Ultérieurement, la Cour d'appel a confirmé la décision du syndic — Employés ont formé un pourvoi — Pourvoi a été accueilli — Cessation d'emploi résultant de la faillite donnait lieu à une réclamation prouvable ordinaire au titre des indemnités de cessation d'emploi — Loi sur la faillite et l'insolvabilité, L.R.C. 1985, c. B-3, art. 121 — Loi sur les normes d'emploi, L.R.O. 1980, c. 137, art. 40(1), 40(7), 40a — Employment Standards Amendment Act, 1981, L.O. 1981, c. 22, art. 2(3) — Loi d'interprétation, L.R.O. 1990, c. I.11, art. 10.

Droit du travail — Cessation d'emploi et indemnité de congédiement — Résiliation du contrat d'emploi par l'employeur — Indemnité de cessation d'emploi en vertu de la législation sur les normes du travail

Syndic a procédé à la fermeture des magasins du failli et a payé tous les traitements, commissions et paies de vacances dus aux employés jusqu'à la date de cessation d'emploi — Ministère du travail a déterminé que les employés avaient droit à une indemnité de cessation d'emploi et a présenté une preuve de réclamation au syndic, lequel a rejeté la preuve de réclamation — Ultérieurement, la Cour d'appel a confirmé la décision du syndic — Employés ont formé un pourvoi — Pourvoi a été accueilli — Cessation d'emploi résultant de la faillite donnait lieu à une réclamation prouvable ordinaire au titre des indemnités de cessation d'emploi — Loi sur la faillite et l'insolvabilité, L.R.C. 1985, c. B-3, art. 121 — Loi sur les normes d'emploi, L.R.O. 1980, c. 137, art. 40(1), 40(7), 40a — Employment Standards Amendment Act, 1981, L.O. 1981, c. 22, art. 2(3) — Loi d'interprétation, L.R.O. 1990, c. I.11, art. 10.

An employer which operated a chain of shoe stores was petitioned into bankruptcy on April 13, 1989. A receiving order was made the following day, and on that day the employment of the employer's employees ended. The trustee in bankruptcy paid all wages, salaries, commissions, and vacation pay which had been earned by the employees up to the date on which the receiving order was made. A few months later, the provincial Ministry of Labour audited the employer' records, and determined that the former employees were owed termination pay and vacation pay thereon. The Ministry accordingly filed a proof of claim for these amounts with the trustee. The trustee subsequently disallowed the claims, inter alia, on the grounds that the bankruptcy of the employer did not constitute a dismissal of the employees from employment; thus, no entitlement to severance, termination or vacation pay was triggered under the *Employment Standards Act* (the "ESA"), and there was no claim provable in bankruptcy. The Ministry's appeal to the Ontario Court of Justice (General Division) was allowed. On appeal to the Ontario Court of Appeal, the court overturned the decision and restored the trustee's decision. The employees resumed an appeal to the Supreme Court of Canada which had been discontinued by the Ministry.

Held: The appeal was allowed.

1998 CarswellOnt 1, 154 D.L.R. (4th) 193, 36 O.R. (3d) 418 (headnote only), (sub nom. Rizzo & Rizzo Shoes Ltd. (Bankrupt), Re) 221 N.R. 241, (sub nom. Adrien v. Ontario Ministry of Labour) 98 C.L.L.C. 210-006, 50 C.B.R. (3d) 163, (sub nom. Rizzo & Rizzo Shoes Ltd. (Bankrupt), Re) 106 O.A.C. 1, [1998] 1 S.C.R. 27, 33 C.C.E.L. (2d) 173, 1998 CarswellOnt 2, [1998] 1 S.C.R. 27, [1998] S.C.J. No. 2

Section 40(7) of the ESA provided that where an employee's employment was terminated contrary to the ESA's minimum notice provisions, the employer was required to pay termination pay equal to the amount the employee would have received for the applicable notice period. Section 40a of the ESA further provided that the employer must pay severance pay to each employee whose employment had been terminated, and who had been employed for five years or more. Section 2(3) of the *Employment Standards Amendment Act, 1981* (the "ESAA"), which enacted s. 40a of the ESA, also included a transitional provision such that the amendments did not apply to bankrupt or insolvent employers whose assets had been distributed among creditors or whose proposal under the *Bankruptcy Act* (the "BA") had been accepted prior to the day the amendments received royal assent. A fair, large, and liberal construction of the words "terminated by the employer" was mandated by s. 10 of the *Interpretation Act* if the provisions of the ESA were to be given a meaning consistent with its spirit, purpose, and intention. The purpose of the various provisions of the ESA is to protect employees against the adverse effects of economic dislocation likely to follow from the absence of an opportunity to search for alternative employment. Interpreting ss. 40 and 40a of the ESA to apply only to non-bankruptcy-related terminations was incompatible with the object of that statute, and the objects of the termination and severance pay provisions themselves. Moreover, if the ESA's amendments were not intended to apply to terminations caused by operation of the BA, then the transitional provisions of s. 2(3) of the ESAA would have no readily apparent purpose. The inclusion of s. 2(3) of the ESAA necessarily implied that the severance pay obligation did in fact extend to bankrupt employers. To limit the application of those provisions only to employees not terminated through bankruptcy would lead to absurd results, and defeat the purpose of the ESA. Therefore, termination as a result of an employer's bankruptcy does give rise to an unsecured claim provable in bankruptcy pursuant to s. 121 of the BA for termination and severance pay in accordance with ss. 40 and 40a of the ESA. A declaration that the employer's former employees were entitled to make claims for termination pay, including vacation pay due thereon and severance pay as unsecured creditors, was substitued for the order of the Court of Appeal.

Un employeur, qui exploitait une chaîne de magasins, a fait l'objet de procédures en faillite et a été déclaré failli en date du 13 avril 1989. Une ordonnance de séquestre a été émise le jour suivant et c'est à ce moment que les contrats d'emploi entre l'employeur et ses employés ont pris fin. Le syndic a versé tous les traitements, salaires, commissions et paies de vacances gagnés par les employés à la date de l'ordonnance de séquestre. Quelques mois plus tard, le ministère du Travail de la province a procédé à la vérification des livres de l'employeur et déterminé que les employés avaient droit à une indemnité de cessation d'emploi de même que le montant y afférent à titre de paie de vacances. Le ministère a donc soumis une preuve de réclamation à l'égard de ces montants au syndic. Le syndic a rejeté la preuve de réclamation au motif, notamment, que la faillite ne constituait pas un congédiement des employés, et ne donnait donc pas droit à une indemnité de cessation d'emploi, une indemnité de licenciement ni une paie de vacances en vertu de la *Loi sur les normes d'emploi* (la « LNE »). Par conséquent, il ne pouvait y avoir de réclamation prouvable à ce titre. Le pourvoi du ministère à la Cour de l'Ontario (Division générale) a été accueilli. En appel à la Cour d'appel de l'Ontario, la Cour a infirmé le jugement de première instance et a confirmé la décision du syndic. Le ministère s'est désisté de son pourvoi et les employés ont repris le pourvoi à la Cour suprême du Canada.

Arrêt: Le pourvoi a été accueilli.

L'article 40(7) de la LNE prévoyait que, lorsque le contrat d'emploi était résilié sans respecter les dispositions de la LNE relatives à l'avis minimal de cessation d'emploi, l'employeur était tenu de verser une indemnité égale au montant que l'employé aurait reçu pour la période d'avis applicable. D'autre part, l'art. 40a de la LNE prévoyait que l'employeur devait verser une indemnité de cessation d'emploi à chaque employé dont le contrat d'emploi a été résilié et qui travaillait pour l'employeur depuis cinq ans ou plus. L'article 2(3) de la *Employment Standards Amendment Act, 1981* (la « ESAA »), qui édictait l'entrée en vigueur l'art. 40a de la LNE, comprenait aussi une disposition transitoire afin que les amendements ne s'appliquent pas aux employeurs faillis ou insolvables dont les biens avaient été distribués aux créanciers et dont la proposition concordataire en vertu de la *Loi sur la faillite et l'insolvabilité* (la « LFI ») avait été acceptée avant le jour où les amendements ont reçu la sanction royale. L'article 10 de la *Loi d'interprétation* commandait une interprétation juste, généreuse et libérale des mots « l'employeur licencie » afin que les dispositions de la

1998 CarswellOnt 1, 154 D.L.R. (4th) 193, 36 O.R. (3d) 418 (headnote only), (sub nom. Rizzo & Rizzo Shoes Ltd. (Bankrupt), Re) 221 N.R. 241, (sub nom. Adrien v. Ontario Ministry of Labour) 98 C.L.L.C. 210-006, 50 C.B.R. (3d) 163, (sub nom. Rizzo & Rizzo Shoes Ltd. (Bankrupt), Re) 106 O.A.C. 1, [1998] 1 S.C.R. 27, 33 C.C.E.L. (2d) 173, 1998 CarswellOnt 2, [1998] 1 S.C.R. 27, [1998] S.C.J. No. 2

LNE aient un sens qui s'accorde avec l'esprit, l'objet et l'intention de cette loi. L'objectif des diverses dispositions de la LNE est de protéger les employés contre les effets nuisibles d'un bouleversement économique soudain qui peuvent survenir en raison de l'absence de la possibilité de chercher un autre emploi. Interpréter les art. 40 et 40a de la LNE de manière à ce qu'ils s'appliquent uniquement lorsque des cessations d'emploi ne résultent pas d'une faillite était contraire à l'objet de cette loi et même à l'objet des dispositions sur l'indemnité de cessation d'emploi. En outre, si les amendements à la LNE n'étaient pas censés s'appliquer aux cessations d'emploi opérées par la LFI, alors les dispositions transitoires de l'art. 2(3) de la ESAA sembleraient dépourvues d'objet. L'inclusion de l'art. 2(3) de la ESAA impliquait nécessairement que l'obligation de verser une indemnité de cessation d'emploi s'étendait aussi aux employeurs faillis. Restreindre l'application de ces dispositions aux seuls employés non licenciés par suite d'une faillite mènerait à des résultats absurdes et viderait la LNE de son objet. Ainsi, aux termes de l'art. 121 de la LFI, la cessation d'emploi découlant de la faillite de l'employeur donne lieu à une réclamation prouvable ordinaire dans la faillite, à titre d'indemnité de licenciement et d'indemnité de cessation d'emploi, conformément aux art. 40 et 40a de la LNE. Une ordonnance déclarant que les anciens employés de l'employeur ont le droit de présenter des demandes d'indemnité de licenciement, y compris la paie de vacances y afférent, et des demandes d'indemnité de cessation d'emploi en tant que créanciers ordinaires a été substituée à l'ordonnance de la Cour d'appel.

Cases considered by / Jurisprudence citée par *Iacobucci J.*:

Abrahams v. Canada (Attorney General), [1983] 1 S.C.R. 2, 142 D.L.R. (3d) 1, 46 N.R. 185, 83 C.L.L.C. 14,010 (S.C.C.) — referred to

British Columbia (Director of Employment Standards) v. Eland Distributors Ltd. (Trustee of), 40 C.B.R. (3d) 25, [1996] 7 W.W.R. 652, 21 B.C.L.R. (3d) 91 (B.C. S.C.) — considered

Canada (Procureure générale) c. Hydro-Québec, (sub nom. *R v. Hydro-Québec)* 118 C.C.C. (3d) 97, (sub nom. *R. v. Hydro-Québec)* 151 D.L.R. (4th) 32, 9 C.R. (5th) 157, (sub nom. *R. v. Hydro-Québec)* 217 N.R. 241, (sub nom. *R. v. Hydro-Québec)* [1997] 3 S.C.R. 213, 24 C.E.L.R. (N.S.) 167 (S.C.C.) — referred to

Friesen v. R., 95 D.T.C. 5551, (sub nom. *Friesen v. Canada)* [1995] 3 S.C.R. 103, (sub nom. *Friesen v. Minister of National Revenue)* 186 N.R. 243, (sub nom. *Friesen v. Minister of National Revenue)* 102 F.T.R. 238 (note), (sub nom. *Friesen v. Canada)* 127 D.L.R. (4th) 193, (sub nom. *Friesen v. Canada)* [1995] 2 C.T.C. 369 (S.C.C.) — referred to

Hills v. Canada (Attorney General), 88 C.L.L.C. 14,011, [1988] 1 S.C.R. 513, 48 D.L.R. (4th) 193, 84 N.R. 86, 30 Admin. L.R. 187 (S.C.C.) — referred to

Kemp Products Ltd., Re (1978), 27 C.B.R. (N.S.) 1 (Ont. S.C.) — distinguished

Machtinger v. HOJ Industries Ltd., 40 C.C.E.L. 1, [1992] 1 S.C.R. 986, (sub nom. *Lefebvre v. HOJ Industries Ltd.; Machtinger v. HOJ Industries Ltd.)* 53 O.A.C. 200, 91 D.L.R. (4th) 491, 7 O.R. (3d) 480n, (sub nom. *Lefebvre v. HOJ Industries Ltd.; Machtinger v. HOJ Industries Ltd.)* 136 N.R. 40, 92 C.L.L.C. 14,022 (S.C.C.) — considered

Malone Lynch Securities Ltd., Re, [1972] 3 O.R. 725, 17 C.B.R. (N.S.) 105, 29 D.L.R. (3d) 387 (Ont. S.C.) — not followed

Mills-Hughes v. Raynor (1988), 19 C.C.E.L. 6, 47 D.L.R. (4th) 381, 25 O.A.C. 248, 38 B.L.R. 211, 68 C.B.R. (N.S.) 179, 63 O.R. (2d) 343 (Ont. C.A.) — considered

1998 CarswellOnt 1, 154 D.L.R. (4th) 193, 36 O.R. (3d) 418 (headnote only), (sub nom. Rizzo & Rizzo Shoes Ltd. (Bankrupt), Re) 221 N.R. 241, (sub nom. Adrien v. Ontario Ministry of Labour) 98 C.L.L.C. 210-006, 50 C.B.R. (3d) 163, (sub nom. Rizzo & Rizzo Shoes Ltd. (Bankrupt), Re) 106 O.A.C. 1, [1998] 1 S.C.R. 27, 33 C.C.E.L. (2d) 173, 1998 CarswellOnt 2, [1998] 1 S.C.R. 27, [1998] S.C.J. No. 2

R. v. Morgentaler, 157 N.R. 97, 125 N.S.R. (2d) 81, 349 A.P.R. 81, [1993] 3 S.C.R. 463, 107 D.L.R. (4th) 537, 85 C.C.C. (3d) 118, 25 C.R. (4th) 179 (S.C.C.) — considered

R. v. Paul, [1982] 1 S.C.R. 621, 27 C.R. (3d) 193, 67 C.C.C. (2d) 97, 138 D.L.R. (3d) 455, 42 N.R. 1 (S.C.C.) — referred to

R. v. TNT Canada Inc. (1996), 17 C.C.E.L. (2d) 1, 131 D.L.R. (4th) 289, 96 C.L.L.C. 210-015, 87 O.A.C. 326, 27 O.R. (3d) 546 (Ont. C.A.) — considered

R. v. Vasil, [1981] 1 S.C.R. 469, 20 C.R. (3d) 193, 58 C.C.C. (2d) 97, 35 N.R. 451, 121 D.L.R. (3d) 41 (S.C.C.) — referred to

R. v. Z. (D.A.), 16 C.R. (4th) 133, [1992] 2 S.C.R. 1025, 76 C.C.C. (3d) 97, 5 Alta. L.R. (3d) 1, 140 N.R. 327, 131 A.R. 1, 25 W.A.C. 1 (S.C.C.) — referred to

Royal Bank v. Sparrow Electric Corp., 193 A.R. 321, 135 W.A.C. 321, [1997] 2 W.W.R. 457, 46 Alta. L.R. (3d) 87, 208 N.R. 161, 143 D.L.R. (4th) 385, 44 C.B.R. (3d) 1, [1997] 1 S.C.R. 411, (sub nom. *R. v. Royal Bank*) 97 D.T.C. 5089 (S.C.C.) — referred to

Telegram Publishing Co. v. Zwelling (1972), 1 L.A.C. (2d) 1 (Ont. Arb. Bd.) — considered

U.F.C.W., Local 617P v. Royal Dressed Meats Inc. (Trustee of) (1989), 76 C.B.R. (N.S.) 86, 70 O.R. (2d) 455, 63 D.L.R. (4th) 603 (Ont. S.C.) — referred to

Verdun v. Toronto Dominion Bank, 94 O.A.C. 211, 203 N.R. 60, [1996] 3 S.C.R. 550, 139 D.L.R. (4th) 415, 28 B.L.R. (2d) 121, 12 C.C.L.S. 139 (S.C.C.) — referred to

Wallace v. United Grain Growers Ltd. (1997), 152 D.L.R. (4th) 1, 219 N.R. 161 (S.C.C.) — referred to

Statutes considered / Législation citée:

Bankruptcy and Insolvency Act/Faillité et l'insolvabilité, Loi sur la, R.S.C./L.R.C. 1985, c. B-3

Generally — referred to

s. 121(1) — considered

Employment Standards Act, R.S.O. 1970, c. 147

s. 13 — referred to

s. 13(2) — considered

Employment Standards Act, 1974, S.O. 1974, c. 112

s. 40(7) — considered

1998 CarswellOnt 1, 154 D.L.R. (4th) 193, 36 O.R. (3d) 418 (headnote only), (sub nom. Rizzo & Rizzo Shoes Ltd. (Bankrupt), Re) 221 N.R. 241, (sub nom. Adrien v. Ontario Ministry of Labour) 98 C.L.L.C. 210-006, 50 C.B.R. (3d) 163, (sub nom. Rizzo & Rizzo Shoes Ltd. (Bankrupt), Re) 106 O.A.C. 1, [1998] 1 S.C.R. 27, 33 C.C.E.L. (2d) 173, 1998 CarswellOnt 2, [1998] 1 S.C.R. 27, [1998] S.C.J. No. 2

Employment Standards Act, R.S.O. 1980, c. 137

Generally — referred to

s. 7(5) [en. 1986, c. 51, s. 2] — considered

s. 40 [am. 1981, c. 22, s. 1; am. 1987, c. 30, s. 4] — considered

s. 40(1) [rep. & sub. 1987, c. 30, s. 4(1)] — considered

s. 40(2) — referred to

s. 40(5) [rep. & sub. 1981, c. 22, s. 1(1)] — referred to

s. 40(7)(a) [en. 1981, c. 22, s. 1(3)] — considered

s. 40a [en. 1981, c. 22, s. 2(1)] — considered

s. 40a(1) [en. 1981, c. 22, s. 2(1)] — considered

s. 40a(1)(a) [en. 1981, c. 22, s. 2(1)] — referred to

s. 40a(1a) [en. 1987, c. 30, s. 5(1)] — considered

Employment Standards Amendment Act, 1981, S.O. 1981, c. 22

s. 2(1) — considered

s. 2(3) — considered

Interpretation Act, R.S.O. 1980, c. 219

s. 10 — considered

Interpretation Act/Interprétation, Loi d', R.S.O./L.R.O. 1990, c. I.11

s. 10 — considered

s. 17 — considered

Labour Relations and Employment Statute Law Amendment Act, 1995/Relations de travail et l'emploi, Loi de 1995 modifiant des lois en ce qui concerne les, S.O./L.O. 1995, c. 1

s. 74(1) — considered

s. 75(1) — considered

1998 CarswellOnt 1, 154 D.L.R. (4th) 193, 36 O.R. (3d) 418 (headnote only), (sub nom. Rizzo & Rizzo Shoes Ltd. (Bankrupt), Re) 221 N.R. 241, (sub nom. Adrien v. Ontario Ministry of Labour) 98 C.L.L.C. 210-006, 50 C.B.R. (3d) 163, (sub nom. Rizzo & Rizzo Shoes Ltd. (Bankrupt), Re) 106 O.A.C. 1, [1998] 1 S.C.R. 27, 33 C.C.E.L. (2d) 173, 1998 CarswellOnt 2, [1998] 1 S.C.R. 27, [1998] S.C.J. No. 2
APPEAL by employees of bankrupt employer from decision reported at (1995), 30 C.B.R. (3d) 1, 9 C.C.E.L. (2d) 264, 22 O.R. (3d) 385, (sub nom. *Ontario Ministry of Labour v. Rizzo & Rizzo Shoes Ltd.)* 95 C.L.L.C. 210-020, (sub nom. *Re Rizzo & Rizzo Shoes Ltd. (Bankrupt))* 80 O.A.C. 201 (C.A.), reversing decision reported at (1991), 11 C.B.R. (3d) 246, 6 O.R. (3d) 441, 92 C.L.L.C. 14,013 (Gen. Div.), reversing disallowance of claim by trustee in bankruptcy.

POURVOI interjeté par les employés d'un employeur failli à l'encontre d'un arrêt publié à (1995), 30 C.B.R. (3d) 1, 9 C.C.E.L. (2d) 264, 22 O.R. (3d) 385, (sub nom. *Ontario Ministry of Labour v. Rizzo & Rizzo Shoes Ltd.)* 95 C.L.L.C. 210-020, (sub nom. *Re Rizzo & Rizzo Shoes Ltd. (Bankrupt))* 80 O.A.C. 201 (C.A.), infirmant un arrêt publié à (1991), 11 C.B.R. (3d) 246, 6 O.R. (3d) 441, 92 C.L.L.C. 14,013 (Gen. Div.), infirmant le rejet par le syndic d'une preuve de réclamation dans la faillite.

The judgment of the court was delivered by *Iacobucci J.*:

1 This is an appeal by the former employees of a now bankrupt employer from an order disallowing their claims for termination pay (including vacation pay thereon) and severance pay. The case turns on an issue of statutory interpretation. Specifically, the appeal decides whether, under the relevant legislation in effect at the time of the bankruptcy, employees are entitled to claim termination and severance payments where their employment has been terminated by reason of their employer's bankruptcy.

1. Facts

2 Prior to its bankruptcy, Rizzo & Rizzo Shoes Limited ("Rizzo") owned and operated a chain of retail shoe stores across Canada. Approximately 65% of those stores were located in Ontario. On April 13, 1989, a petition in bankruptcy was filed against the chain. The following day, a receiving order was made on consent in respect of Rizzo's property. Upon the making of that order, the employment of Rizzo's employees came to an end.

3 Pursuant to the receiving order, the respondent, Zittrer, Siblin & Associates, Inc. (the "Trustee") was appointed as trustee in bankruptcy of Rizzo's estate. The Bank of Nova Scotia privately appointed Peat Marwick Limited ("PML") as receiver and manager. By the end of July, 1989, PML had liquidated Rizzo's property and assets and closed the stores. PML paid all wages, salaries, commissions and vacation pay that had been earned by Rizzo's employees up to the date on which the receiving order was made.

4 In November 1989, the Ministry of Labour for the Province of Ontario (Employment Standards Branch) (the "Ministry") audited Rizzo's records to determine if there was any outstanding termination or severance pay owing to former employees under the *Employment Standards Act*, R.S.O. 1980, c. 137, as amended (the "*ESA*"). On August 23, 1990, the Ministry delivered a proof of claim to the respondent Trustee on behalf of the former employees of Rizzo for termination pay and vacation pay thereon in the amount of approximately $2.6 million and for severance pay totalling $14,215. The Trustee disallowed the claims, issuing a Notice of Disallowance on January 28, 1991. For the purposes of this appeal, the relevant ground for disallowing the claim was the Trustee's opinion that the bankruptcy of an employer does not constitute a dismissal from employment and thus, no entitlement to severance, termination or vacation pay is created under the *ESA*.

5 The Ministry appealed the Trustee's decision to the Ontario Court (General Division) which reversed the Trustee's disallowance and allowed the claims as unsecured claims provable in bankruptcy. On appeal, the Ontario Court of Appeal overturned the trial court's ruling and restored the decision of the Trustee. The Ministry sought leave to appeal from the Court of Appeal judgment, but discontinued its application on August 30, 1993. Following the discontinuance of the appeal, the Trustee paid a dividend to Rizzo's creditors, thereby leaving significantly less funds in the estate. Subsequently, the appellants, five former employees of Rizzo, moved to set aside the discontinuance, add themselves as parties to the proceedings, and requested an order granting them leave to appeal. This Court's order granting those applications was issued on December 5, 1996.

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2. Relevant Statutory Provisions

6 The relevant versions of the *Bankruptcy Act* (now the *Bankruptcy and Insolvency Act*) and the *Employment Standards Act* for the purposes of this appeal are R.S.C. 1985, c. B-3 (the "*BA*"), and R.S.O. 1980, c. 137, as amended to April 14, 1989 (the "*ESA*") respectively:

Employment Standards Act, R.S.O. 1980, c. 137, as amended:

7.--

(5) Every contract of employment shall be deemed to include the following provision:

All severance pay and termination pay become payable and shall be paid by the employer to the employee in two weekly instalments beginning with the first full week following termination of employment and shall be allocated to such weeks accordingly. This provision does not apply to severance pay if the employee has elected to maintain a right of recall as provided in subsection 40a (7) of the *Employment Standards Act*.

40.-- (1) No employer shall terminate the employment of an employee who has been employed for three months or more unless the employee gives,

(a) one weeks notice in writing to the employee if his or her period of employment is less than one year;

(b) two weeks notice in writing to the employee if his or her period of employment is one year or more but less than three years;

(c) three weeks notice in writing to the employee if his or her period of employment is three years or more but less than four years;

(d) four weeks notice in writing to the employee if his or her period of employment is four years or more but less than five years;

(e) five weeks notice in writing to the employee if his or her period of employment is five years or more but less than six years;

(f) six weeks notice in writing to the employee if his or her period of employment is six years or more but less than seven years;

(g) seven weeks notice in writing to the employee if his or her period of employment is seven years or more but less than eight years;

(h) eight weeks notice in writing to the employee if his or her period of employment is eight years or more,

and such notice has expired.

.....

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(7) Where the employment of an employee is terminated contrary to this section,

(a) the employer shall pay termination pay in an amount equal to the wages that the employee would have been entitled to receive at his regular rate for a regular non-overtime work week for the period of notice prescribed by subsection (1) or (2), and any wages to which he is entitled;

. . . . .

40*a* ...

(1a) Where,

(a) fifty or more employees have their employment terminated by an employer in a period of six months or less and the terminations are caused by the permanent discontinuance of all or part of the business of the employer at an establishment; or

(b) one or more employees have their employment terminated by an employer with a payroll of $2.5 million or more,

the employer shall pay severance pay to each employee whose employment has been terminated and who has been employed by the employer for five or more years.

Employment Standards Amendment Act, 1981, S.O. 1981, c. 22

2.—(1) Part XII of the said Act is amended by adding thereto the following section:

(3) Section 40*a* of the said Act does not apply to an employer who became a bankrupt or an insolvent person within the meaning of the *Bankruptcy Act* (Canada) and whose assets have been distributed among his creditors or to an employer whose proposal within the meaning of the *Bankruptcy Act* (Canada) has been accepted by his creditors in the period from and including the 1st day of January, 1981, to and including the day immediately before the day this Act receives Royal Assent.

Bankruptcy Act, R.S.C. 1985, c. B-3

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

Interpretation Act, R.S.O. 1990, c. I.11

10. Every Act shall be deemed to be remedial, whether its immediate purport is to direct the doing of any thing that the Legislature deems to be for the public good or to prevent or punish the doing of any thing that it deems to be contrary to the public good, and shall accordingly receive such fair, large and liberal construction and interpretation as will best ensure the attainment of the object of the Act according to its true intent, meaning and spirit.

. . . . .

1998 CarswellOnt 1, 154 D.L.R. (4th) 193, 36 O.R. (3d) 418 (headnote only), (sub nom. Rizzo & Rizzo Shoes Ltd. (Bankrupt), Re) 221 N.R. 241, (sub nom. Adrien v. Ontario Ministry of Labour) 98 C.L.L.C. 210-006, 50 C.B.R. (3d) 163, (sub nom. Rizzo & Rizzo Shoes Ltd. (Bankrupt), Re) 106 O.A.C. 1, [1998] 1 S.C.R. 27, 33 C.C.E.L. (2d) 173, 1998 CarswellOnt 2, [1998] 1 S.C.R. 27, [1998] S.C.J. No. 2

> 17. The repeal or amendment of an Act shall be deemed not to be or to involve any declaration as to the previous state of the law.

3. Judicial History

A. Ontario Court (General Division) (1991), 6 O.R. (3d) 441 (Ont. Gen. Div.)

7 Having disposed of several issues which do not arise on this appeal, Farley J. turned to the question of whether termination pay and severance pay are provable claims under the *BA*. Relying on *U.F.C.W., Local 617P v. Royal Dressed Meats Inc. (Trustee of)* (1989), 76 C.B.R. (N.S.) 86 (Ont. S.C.), he found that it is clear that claims for termination and severance pay are provable in bankruptcy where the statutory obligation to provide such payments arose prior to the bankruptcy. Accordingly, he reasoned that the essential matter to be resolved in the case at bar was whether bankruptcy acted as a termination of employment thereby triggering the termination and severance pay provisions of the *ESA* such that liability for such payments would arise on bankruptcy as well.

8 In addressing this question, Farley J. began by noting that the object and intent of the *ESA* is to provide minimum employment standards and to benefit and protect the interests of employees. Thus, he concluded that the *ESA* is remedial legislation and as such it should be interpreted in a fair, large and liberal manner to ensure that its object is attained according to its true meaning, spirit and intent.

9 Farley J. then held that denying employees in this case the right to claim termination and severance pay would lead to the arbitrary and unfair result that an employee whose employment is terminated just prior to a bankruptcy would be entitled to termination and severance pay, whereas one whose employment is terminated by the bankruptcy itself would not have that right. This result, he stated, would defeat the intended working of the *ESA*.

10 Farley J. saw no reason why the claims of the employees in the present case would not generally be contemplated as wages or other claims under the *BA*. He emphasized that the former employees in the case at bar had not alleged that termination pay and severance pay should receive a priority in the distribution of the estate, but merely that they are provable (unsecured and unpreferred) claims in a bankruptcy. For this reason, he found it inappropriate to make reference to authorities whose focus was the interpretation of priority provisions in the *BA*.

11 Even if bankruptcy does not terminate the employment relationship so as to trigger the *ESA* termination and severance pay provisions, Farley J. was of the view that the employees in the instant case would nevertheless be entitled to such payments as these were liabilities incurred prior to the date of the bankruptcy by virtue of s. 7(5) of the *ESA*. He found that s. 7(5) deems every employment contract to include a provision to provide termination and severance pay following the termination of employment and concluded that a contingent obligation is thereby created for a bankrupt employer to make such payments from the outset of the relationship, long before the bankruptcy.

12 Farley J. also considered s. 2(3) of the *Employment Standards Amendment Act, 1981*, S.O. 1981, c. 22 (the "*ESAA*"), which is a transitional provision that exempted certain bankrupt employers from the newly introduced severance pay obligations until the amendments received royal assent. He was of the view that this provision would not have been necessary if the obligations of employers upon termination of employment had not been intended to apply to bankrupt employers under the *ESA*. Farley J. concluded that the claim by Rizzo's former employees for termination pay and severance pay could be provided as unsecured and unpreferred debts in a bankruptcy. Accordingly, he allowed the appeal from the decision of the Trustee.

B. Ontario Court of Appeal (1995), 22 O.R (3d) 385

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13 Austin J.A., writing for a unanimous court, began his analysis of the principal issue in this appeal by focussing upon the language of the termination pay and severance pay provisions of the *ESA*. He noted, at p. 390, that the termination pay provisions use phrases such as "[n]o employer shall terminate the employment of an employee" (s. 40(1)), "the notice required by an employer to terminate the employment" (s. 40(2)), and "[a]n employer who has terminated or proposes to terminate the employment of employees" (s. 40(5)). Turning to severance pay, he quoted s. 40*a*(1)(*a*) (at p. 391) which includes the phrase "employees have their employment terminated by an employer". Austin J.A. concluded that this language limits the obligation to provide termination and severance pay to situations in which the employer terminates the employment. The operation of the *ESA*, he stated, is not triggered by the termination of employment resulting from an act of law such as bankruptcy.

14 In support of his conclusion, Austin J.A. reviewed the leading cases in this area of law. He cited *Re Malone Lynch Securities Ltd.*, [1972] 3 O.R. 725 (Ont. S.C.), wherein Houlden J. (as he then was) concluded that the *ESA* termination pay provisions were not designed to apply to a bankrupt employer. He also relied upon *Re Kemp Products Ltd.* (1978), 27 C.B.R. (N.S.) 1 (Ont. S.C.), for the proposition that the bankruptcy of a company at the instance of a creditor does not constitute dismissal. He concluded as follows at p. 395:

> The plain language of ss. 40 and 40*a* does not give rise to any liability to pay termination or severance pay except where the employment is terminated by the employer. In our case, the employment was terminated, not by the employer, but by the making of a receiving order against Rizzo on April 14, 1989, following a petition by one of its creditors. No entitlement to either termination or severance pay ever arose.

15 Regarding s. 7(5) of the *ESA*, Austin J.A. rejected the trial judge's interpretation and found that the section does not create a liability. Rather, in his opinion, it merely states when a liability otherwise created is to be paid and therefore it was not considered relevant to the issue before the court. Similarly, Austin J.A. did not accept the lower court's view of s. 2(3), the transitional provision in the *ESAA*. He found that that section had no effect upon the intention of the Legislature as evidenced by the terminology used in ss. 40 and 40*a*.

16 Austin J.A. concluded that, because the employment of Rizzo's former employees was terminated by the order of bankruptcy and not by the act of the employer, no liability arose with respect to termination, severance or vacation pay. The order of the trial judge was set aside and the Trustee's disallowance of the claims was restored.

4. Issues

17 This appeal raises one issue: does the termination of employment caused by the bankruptcy of an employer give rise to a claim provable in bankruptcy for termination pay and severance pay in accordance with the provisions of the *ESA*?

5. Analysis

18 The statutory obligation upon employers to provide both termination pay and severance pay is governed by ss. 40 and 40*a* of the *ESA*, respectively. The Court of Appeal noted that the plain language of those provisions suggests that termination pay and severance pay are payable only when the employer terminates the employment. For example, the opening words of s. 40(1) are: "No employer shall terminate the employment of an employee...." Similarly, s. 40*a*(1) begins with the words, "Where...fifty or more employees have their employment terminated by an employer...." Therefore, the question on which this appeal turns is whether, when bankruptcy occurs, the employment can be said to be terminated "by the employer".

19 The Court of Appeal answered this question in the negative, holding that, where an employer is petitioned into bankruptcy by a creditor, the employment of its employees is not terminated "by the employer", but rather by oper-

1998 CarswellOnt 1, 154 D.L.R. (4th) 193, 36 O.R. (3d) 418 (headnote only), (sub nom. Rizzo & Rizzo Shoes Ltd. (Bankrupt), Re) 221 N.R. 241, (sub nom. Adrien v. Ontario Ministry of Labour) 98 C.L.L.C. 210-006, 50 C.B.R. (3d) 163, (sub nom. Rizzo & Rizzo Shoes Ltd. (Bankrupt), Re) 106 O.A.C. 1, [1998] 1 S.C.R. 27, 33 C.C.E.L. (2d) 173, 1998 CarswellOnt 2, [1998] 1 S.C.R. 27, [1998] S.C.J. No. 2

ation of law. Thus, the Court of Appeal reasoned that, in the eircumstanees of the present ease, the *ESA* termination pay and severance pay provisions were not applicable and no obligations arose. In answer, the appellants submit that the phrase "terminated by the employer" is best interpreted as refleeting a distinction between involuntary and voluntary termination of employment. It is their position that this language was intended to relieve employers of their obligation to pay termination and severance pay when employees leave their jobs voluntarily. However, the appellants maintain that where an employee's employment is involuntarily terminated by reason of their employer's bankruptcy, this constitutes termination "by the employer" for the purpose of triggering entitlement to termination and severance pay under the *ESA*.

20 At the heart of this conflict is an issue of statutory interpretation. Consistent with the findings of the Court of Appeal, the plain meaning of the words of the provisions here in question appears to restrict the obligation to pay termination and severance pay to those employers who have aetively terminated the employment of their employees. At first blush, bankruptcy does not fit comfortably into this interpretation. However, with respect, I believe this analysis is incomplete.

21 Although much has been written about the interpretation of legislation (see, e.g., Ruth Sullivan, *Statutory Interpretation* (1997); Ruth Sullivan, *Driedger on the Construction of Statutes* (3rd ed. 1994) (hereinafter "*Construction of Statutes*"); Pierre-André Côté, *The Interpretation of Legislation in Canada* (2nd ed. 1991), Elmer Driedger in *Construction of Statutes* (2nd ed. 1983) best encapsulates the approach upon which I prefer to rely. He recognizes that statutory interpretation cannot be founded on the wording of the legislation alone. At p. 87 he states:

> Today there is only one principle or approach, namely, the words of an Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Aet, the object of the Act, and the intention of Parliament.

Recent cases which have cited the above passage with approval include: *Canada (Procureure générale) c. Hydro-Québec*, (sub nom. *R. v. Hydro-Québec)* [1997] 3 S.C.R. 213 (S.C.C.); *Royal Bank v. Sparrow Electric Corp.*, [1997] 1 S.C.R. 411 (S.C.C.); *Verdun v. Toronto Dominion Bank*, [1996] 3 S.C.R. 550 (S.C.C.); *Friesen v. R.*, [1995] 3 S.C.R. 103 (S.C.C.).

22 I also rely upon s. 10 of the *Interpretation Act*, R.S.O. 1980, e. 219, which provides that every Act "shall be deemed to be remedial" and directs that every Act shall "receive such fair, large and liberal construction and interpretation as will best ensure the attainment of the object of the Act according to its true intent, meaning and spirit."

23 Although the Court of Appeal looked to the plain meaning of the specific provisions in question in the present case, with respect, I believe that the court did not pay sufficient attention to the scheme of the *ESA*, its object or the intention of the legislature; nor was the context of the words in issue appropriately recognized. I now turn to a discussion of these issues.

24 In *Machtinger v. HOJ Industries Ltd.*, [1992] 1 S.C.R. 986 (S.C.C.), at p. 1002, the majority of this Court recognized the importance that our society accords to employment and the fundamental role that it has assumed in the life of the individual. The manner in which employment can be terminated was said to be equally important (see also *Wallace v. United Grain Growers Ltd.* (1997), 219 N.R. 161 (S.C.C.). It was in this context that the majority in *Machtinger* described, at p. 1003, the object of the *ESA* as being the protection of "...the interests of employees by requiring employers to comply with certain minimum standards, including minimum periods of notice of termination." Accordingly, the majority concluded, at p. 1003, that, "...an interpretation of the Act which encourages employers to comply with the minimum requirements of the Act, and so extends its protection to as many employees as possible, is to be favoured over one that does not."

25 The objects of the termination and severance pay provisions themselves are also broadly premised upon the

1998 CarswellOnt 1, 154 D.L.R. (4th) 193, 36 O.R. (3d) 418 (headnote only), (sub nom. Rizzo & Rizzo Shoes Ltd. (Bankrupt), Re) 221 N.R. 241, (sub nom. Adrien v. Ontario Ministry of Labour) 98 C.L.L.C. 210-006, 50 C.B.R. (3d) 163, (sub nom. Rizzo & Rizzo Shoes Ltd. (Bankrupt), Re) 106 O.A.C. 1, [1998] 1 S.C.R. 27, 33 C.C.E.L. (2d) 173, 1998 CarswellOnt 2, [1998] 1 S.C.R. 27, [1998] S.C.J. No. 2
need to protect employees. Section 40 of the *ESA* requires employers to give their employees reasonable notice of termination based upon length of service. One of the primary purposes of this notice period is to provide employees with an opportunity to take preparatory measures and seek alternative employment. It follows that s. 40(7)(a), which provides for termination pay in lieu of notice when an employer has failed to give the required statutory notice, is intended to "cushion" employees against the adverse effects of economic dislocation likely to follow from the absence of an opportunity to search for alternative employment. (Innis Christie, Geoffrey England and Brent Cotter, *Employment Law in Canada* (2nd ed. 1993), at pp. 572-81.

26 Similarly, s. 40*a*, which provides for severance pay, acts to compensate long-serving employees for their years of service and investment in the employer's business and for the special losses they suffer when their employment terminates. In *R. v. TNT Canada Inc.* (1996), 27 O.R. (3d) 546 (Ont. C.A.), Robins J.A. quoted with approval at pp. 556-57 from the words of D.D. Carter in the course of an employment standards determination in *Telegram Publishing Co. v. Zwelling* (1972), 1 L.A.C. (2d) 1 (Ont. Arb. Bd.), at p. 19, wherein he described the role of severance pay as follows:

> Severance pay recognizes that an employee does make an investment in his employer's business -- the extent of this investment being directly related to the length of the employee's service. This investment is the seniority that the employee builds up during his years of service....Upon termination of the employment relationship, this investment of years of service is lost, and the employee must start to rebuild seniority at another place of work. The severance pay, based on length of service, is some compensation for this loss of investment.

27 In my opinion, the consequences or effects which result from the Court of Appeal's interpretation of ss. 40 and 40*a* of the *ESA* are incompatible with both the object of the Act and with the object of the termination and severance pay provisions themselves. It is a well established principle of statutory interpretation that the legislature does not intend to produce absurd consequences. According to Côté, *supra*, an interpretation can be considered absurd if it leads to ridiculous or frivolous consequences, if it is extremely unreasonable or inequitable, if it is illogical or incoherent, or if it is incompatible with other provisions or with the object of the legislative enactment (at pp. 378-80). Sullivan echoes these comments noting that a label of absurdity can be attached to interpretations which defeat the purpose of a statute or render some aspect of it pointless or futile (Sullivan, *Construction of Statutes, supra*, at p. 88).

28 The trial judge properly noted that, if the *ESA* termination and severance pay provisions do not apply in circumstances of bankruptcy, those employees 'fortunate' enough to have been dismissed the day before a bankruptcy would be entitled to such payments, but those terminated on the day the bankruptcy becomes final would not be so entitled. In my view, the absurdity of this consequence is particularly evident in a unionized workplace where seniority is a factor in determining the order of lay-off. The more senior the employee, the larger the investment he or she has made in the employer and the greater the entitlement to termination and severance pay. However, it is the more senior personnel who are likely to be employed up until the time of the bankruptcy and who would thereby lose their entitlements to these payments.

29 If the Court of Appeal's interpretation of the termination and severance pay provisions is correct, it would be acceptable to distinguish between employees merely on the basis of the timing of their dismissal. It seems to me that such a result would arbitrarily deprive some employees of a means to cope with the economic dislocation caused by unemployment. In this way the protections of the *ESA* would be limited rather than extended, thereby defeating the intended working of the legislation. In my opinion, this is an unreasonable result.

30 In addition to the termination and severance pay provisions, both the appellants and the respondent relied upon various other sections of the *ESA* to advance their arguments regarding the intention of the legislature. In my view, although the majority of these sections offer little interpretive assistance, one transitional provision is particularly instructive. In 1981, s. 2(1) of the *Employment Standards Amendment Act, 1981*, ("*ESAA*") introduced s.40*a*, the severance pay provision, to the *ESA*. Section 2(2) deemed that provision to come into force on January 1, 1981. Sec-

1998 CarswellOnt 1, 154 D.L.R. (4th) 193, 36 O.R. (3d) 418 (headnote only), (sub nom. Rizzo & Rizzo Shoes Ltd. (Bankrupt), Re) 221 N.R. 241, (sub nom. Adrien v. Ontario Ministry of Labour) 98 C.L.L.C. 210-006, 50 C.B.R. (3d) 163, (sub nom. Rizzo & Rizzo Shoes Ltd. (Bankrupt), Re) 106 O.A.C. 1, [1998] 1 S.C.R. 27, 33 C.C.E.L. (2d) 173, 1998 CarswellOnt 2, [1998] 1 S.C.R. 27, [1998] S.C.J. No. 2
tion 2(3), the transitional provision in question provided as follows:

> 2. ...
>
> (3) Section 40*a* of the said Act does not apply to an employer who became bankrupt or an insolvent person within the meaning of the *Bankruptcy Act* (Canada) and whose assets have been distributed among his creditors or to an employer whose proposal within the meaning of the *Bankruptcy Act* (Canada) has been accepted by his creditors in the period from and including the 1st day of January, 1981, to and including the day immediately before the day this Act receives Royal Assent.

31 The Court of Appeal found that it was neither necessary nor appropriate to determine the intention of the legislature in enacting this provisional subsection. Nevertheless, the court took the position that the intention of the legislature as evidenced by the introductory words of ss. 40 and 40*a* was clear, namely, that termination by reason of a bankruptcy will not trigger the severance and termination pay obligations of the *ESA*. The court held that this intention remained unchanged by the introduction of the transitional provision. With respect, I do not agree with either of these findings. Firstly, in my opinion, the use of legislative history as a tool for determining the intention of the legislature is an entirely appropriate exercise and one which has often been employed by this Court (see, e.g., *R. v. Vasil*, [1981] 1 S.C.R. 469 (S.C.C.), at p. 487; *R. v. Paul*, [1982] 1 S.C.R. 621 (S.C.C.), at pp. 635, 653 and 660). Secondly, I believe that the transitional provision indicates that the Legislature intended that termination and severance pay obligations should arise upon an employers' bankruptcy.

32 In my view, by extending an exemption to employers who became bankrupt and lost control of their assets between the coming into force of the amendment and its receipt of royal assent, s. 2(3) necessarily implies that the severance pay obligation does in fact extend to bankrupt employers. It seems to me that, if this were not the case, no readily apparent purpose would be served by this transitional provision.

33 I find support for my conclusion in the decision of Saunders J. in *Royal Dressed Meats Inc.*, *supra*. Having reviewed s. 2(3) of the *ESAA*, he commented as follows:

> ...any doubt about the intention of the Ontario Legislature has been put to rest, in my opinion, by the transitional provision which introduced severance payments into the *ESA*...it seems to me an inescapable inference that the legislature intended liability for severance payments to arise on a bankruptcy. That intention would, in my opinion, extend to termination payments which are similar in character.

34 This interpretation is also consistent with statements made by the Minister of Labour at the time he introduced the 1981 amendments to the *ESA*. With regard to the new severance pay provision he stated:

> The circumstances surrounding a closure will govern the applicability of the severance pay legislation in some defined situations. For example, a bankrupt or insolvent firm will still be required to pay severance pay to employees to the extent that assets are available to satisfy their claims.
>
> .....
>
> ...the proposed severance pay measures will, as I indicated earlier, be retroactive to January 1 of this year. That retroactive provision, however, will not apply in those cases of bankruptcy and insolvency where the assets have already been distributed or where an agreement on a proposal to creditors has already been reached. [Ontario, Legislative Assembly, *Debates*, No. 36, at pp. 1236-37 (June 4, 1981)]

Moreover, in the legislative debates regarding the proposed amendments the Minister stated:

1998 CarswellOnt 1, 154 D.L.R. (4th) 193, 36 O.R. (3d) 418 (headnote only), (sub nom. Rizzo & Rizzo Shoes Ltd. (Bankrupt), Re) 221 N.R. 241, (sub nom. Adrien v. Ontario Ministry of Labour) 98 C.L.L.C. 210-006, 50 C.B.R. (3d) 163, (sub nom. Rizzo & Rizzo Shoes Ltd. (Bankrupt), Re) 106 O.A.C. 1, [1998] 1 S.C.R. 27, 33 C.C.E.L. (2d) 173, 1998 CarswellOnt 2, [1998] 1 S.C.R. 27, [1998] S.C.J. No. 2

> For purposes of retroactivity, severance pay will not apply to bankruptcies under the Bankruptcy Act where assets have been distributed. However, once this Act receives royal assent, employees in bankruptcy closures will be covered by the severance pay provisions. [Ontario, Legislative Assembly, *Debates*, No. 48, at p. 1699 (June 16, 1981)]

35 Although the frailties of Hansard evidence are many, this Court has recognized that it can play a limited role in the interpretation of legislation. Writing for the Court in *R. v. Morgentaler*, [1993] 3 S.C.R. 463 (S.C.C.), at p. 484, Sopinka J. stated:

> ...until recently the courts have balked at admitting evidence of legislative debates and speeches....The main criticism of such evidence has been that it cannot represent the "intent" of the legislature, an incorporeal body, but that is equally true of other forms of legislative history. Provided that the court remains mindful of the limited reliability and weight of Hansard evidence, it should be admitted as relevant to both the background and the purpose of legislation.

36 Finally, with regard to the scheme of the legislation, since the *ESA* is a mechanism for providing minimum benefits and standards to protect the interests of employees, it can be characterized as benefits-conferring legislation. As such, according to several decisions of this Court, it ought to be interpreted in a broad and generous manner. Any doubt arising from difficulties of language should be resolved in favour of the claimant (see, e.g., *Abrahams v. Canada (Attorney General)*, [1983] 1 S.C.R. 2 (S.C.C.), at p. 10; *Hills v. Canada (Attorney General)*, [1988] 1 S.C.R. 513 (S.C.C.), at p. 537). It seems to me that, by limiting its analysis to the plain meaning of ss. 40 and 40*a* of the *ESA*, the Court of Appeal adopted an overly restrictive approach that is inconsistent with the scheme of the Act.

37 The Court of Appeal's reasons relied heavily upon the decision in *Malone Lynch, supra*. In *Malone Lynch*, Houlden J. held that s. 13, the group termination provision of the former *ESA*, R.S.O. 1970, c. 147, and the predecessor to s. 40 at issue in the present case, was not applicable where termination resulted from the bankruptcy of the employer. Section 13(2) of the *ESA* then in force provided that, if an employer wishes to terminate the employment of 50 or more employees, the employer must give notice of termination for the period prescribed in the regulations, "and until the expiry of such notice the terminations shall not take effect." Houlden J. reasoned that termination of employment through bankruptcy could not trigger the termination payment provision, as employees in this situation had not received the written notice required by the statute, and therefore could not be said to have been terminated in accordance with the Act.

38 Two years after *Malone Lynch* was decided, the 1970 *ESA* termination pay provisions were amended by the *Employment Standards Act, 1974*, S.O. 1974, c. 112. As amended, s. 40(7) of the 1974 *ESA* eliminated the requirement that notice be given before termination can take effect. This provision makes it clear that termination pay is owing where an employer fails to give notice of termination and that employment terminates irrespective of whether or not proper notice has been given. Therefore, in my opinion it is clear that the *Malone Lynch* decision turned on statutory provisions which are materially different from those applicable in the instant case. It seems to me that Houlden J.'s holding goes no further than to say that the provisions of the 1970 *ESA* have no application to a bankrupt employer. For this reason, I do not accept the *Malone Lynch* decision as persuasive authority for the Court of Appeal's findings. I note that the courts in *Royal Dressed Meats, supra*, and *British Columbia (Director of Employment Standards) v. Eland Distributors Ltd. (Trustee of)* (1996), 40 C.B.R. (3d) 25 (B.C. S.C.), declined to rely upon *Malone Lynch* based upon similar reasoning.

39 The Court of Appeal also relied upon *Re Kemp Products Ltd., supra*, for the proposition that although the employment relationship will terminate upon an employer's bankruptcy, this does not constitute a "dismissal". I note that this case did not arise under the provisions of the *ESA*. Rather, it turned on the interpretation of the term "dismissal" in what the complainant alleged to be an employment contract. As such, I do not accept it as authoritative

1998 CarswellOnt 1, 154 D.L.R. (4th) 193, 36 O.R. (3d) 418 (headnote only), (sub nom. Rizzo & Rizzo Shoes Ltd. (Bankrupt), Re) 221 N.R. 241, (sub nom. Adrien v. Ontario Ministry of Labour) 98 C.L.L.C. 210-006, 50 C.B.R. (3d) 163, (sub nom. Rizzo & Rizzo Shoes Ltd. (Bankrupt), Re) 106 O.A.C. 1, [1998] 1 S.C.R. 27, 33 C.C.E.L. (2d) 173, 1998 CarswellOnt 2, [1998] 1 S.C.R. 27, [1998] S.C.J. No. 2
jurisprudence in the circumstances of this case. For the reasons discussed above, I also disagree with the Court of Appeal's reliance on *Mills-Hughes v. Raynor* (1988), 63 O.R. (2d) 343 (Ont. C.A.), which cited the decision in *Malone Lynch, supra* with approval.

40 As I see the matter, when the express words of ss. 40 and 40*a* of the *ESA* are examined in their entire context, there is ample support for the conclusion that the words "terminated by the employer" must be interpreted to include termination resulting from the bankruptcy of the employer. Using the broad and generous approach to interpretation appropriate for benefits-conferring legislation, I believe that these words can reasonably bear that construction (see *R. v. Z. (D.A.)*, [1992] 2 S.C.R. 1025 (S.C.C.)). I also note that the intention of the Legislature as evidenced in s. 2(3) of the *ESSA*, clearly favours this interpretation. Further, in my opinion, to deny employees the right to claim *ESA* termination and severance pay where their termination has resulted from their employer's bankruptcy, would be inconsistent with the purpose of the termination and severance pay provisions and would undermine the object of the *ESA*, namely, to protect the interests of as many employees as possible.

41 In my view, the impetus behind the termination of employment has no bearing upon the ability of the dismissed employee to cope with the sudden economic dislocation caused by unemployment. As all dismissed employees are equally in need of the protections provided by the *ESA*, any distinction between employees whose termination resulted from the bankruptcy of their employer and those who have been terminated for some other reason would be arbitrary and inequitable. Further, I believe that such an interpretation would defeat the true meaning, intent and spirit of the *ESA*. Therefore, I conclude that termination as a result of an employer's bankruptcy does give rise to an unsecured claim provable in bankruptcy pursuant to s. 121 of the *BA* for termination and severance pay in accordance with ss. 40 and 40*a* of the *ESA*. Because of this conclusion, I do not find it necessary to address the alternative finding of the trial judge as to the applicability of s. 7(5) of the *ESA*.

42 I note that subsequent to the Rizzo bankruptcy, the termination and severance pay provisions of the *ESA* underwent another amendment. Sections 74(1) and 75(1) of the *Labour Relations and Employment Statute Law Amendment Act, 1995*, S.O. 1995, c. 1, amend those provisions so that they now expressly provide that where employment is terminated by operation of law as a result of the bankruptcy of the employer, the employer will be deemed to have terminated the employment. However, s. 17 of the *Interpretation Act* directs that, "the repeal or amendment of an Act shall be deemed not to be or to involve any declaration as to the previous state of the law." As a result, I note that the subsequent change in the legislation has played no role in determining the present appeal.

6. Disposition and Costs

43 I would allow the appeal and set aside paragraph 1 of the order of the Court of Appeal. In lieu thereof, I would substitute an order declaring that Rizzo's former employees are entitled to make claims for termination pay (including vacation pay due thereon) and severance pay as unsecured creditors. As to costs, the Ministry of Labour led no evidence regarding what effort it made in notifying or securing the consent of the Rizzo employees before it discontinued its application for leave to appeal to this Court on their behalf. In light of these circumstances, I would order that the costs in this Court be paid to the appellant by the Ministry on a party-and-party basis. I would not disturb the orders of the courts below with respect to costs.

Appeal allowed.

Pourvoi accueilli.

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Tab 8

IN RE: DREXEL BURNHAM LAMBERT GROUP INC., ET AL., Debtor

Case No. 90 B 10421 Chapter 11

UNITED STATES BANKRUPTCY COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

148 B.R. 982; 1992 Bankr. LEXIS 2023; 23 Bankr. Ct. Dec. 1315

December 18, 1992, Decided

SUBSEQUENT HISTORY: **[**1]** As Corrected December 22, 1992

CASE SUMMARY:

PROCEDURAL POSTURE: The matter was before the court to determine whether claimants' requests for indemnification of costs and expenses associated with the defense of unresolved underlying third-party actions, in which bankrupt and claimants were named as co-defendants, were disallowed under 11 U.S.C.S. § 502(e)(1)(B).

OVERVIEW: Bankrupt was a senior managing underwriter for several public offerings. Claimants were underwriters and co-underwriters in some of the offerings. Bankrupt and claimants were sued for marketing risky bonds as safe. Bankrupt was not a party to the civil actions due to an automatic stay. Claimants sought indemnification from bankrupt, alleging that various Agreements Among Underwriters (AAU) obligated each underwriter to pay its proportionate share of the defense costs and any resultant judgment or settlement from the civil actions. Also, claimants argued that equities dictated that bankrupt be obligated to pay its share of any judgment. The court held that claimants' indemnification requests for judgments or settlements in pending litigation were disallowed under 11 U.S.C.S. § 502(e)(1)(B) as contingent indemnity claims on which claimants and bankrupt were co-liable. Also, the equities did not permit an exception to the § 502(e)(1)(B) rule. For claimants who submitted AAUs showing a contractual basis for the indemnification of defense costs regardless of liability, their claims were allowed to the extent of any payments already made for bankrupt's share of the defense costs.

OUTCOME: Claimant's indemnification requests for judgments or settlements in pending litigation were disallowed; however, for claimants with a contractual basis for indemnification of defense costs, the court allowed those claims to the extent that claimants had already paid bankrupt's share of those costs.

CORE TERMS: claimant, underwriter, indemnification, offering, contingent, co-underwriters, underlying action, reimbursement, contingent claims, contingency, contractual, proportionate share, underwriting, co-liable, disallowance, issuer, secondarily liable, co-liability, settlement, non-defaulting, remediation, stemming, default, underlying suit, civil actions, good faith, reallocation, irrespective, indemnify, allowance

LexisNexis(R) Headnotes

Bankruptcy Law > Claims > Allowance
[HN1] The application of 11 U.S.C.S. § 502(e)(1)(B) to disallow a claim requires that three elements be established. First, the claim must be for reimbursement or contribution. Second, the party asserting the claim must be liable with the debtor on the claim. Third, the claim must be contingent at the time of its allowance or disallowance.

Bankruptcy Law > Claims > Allowance
[HN2] See 11 U.S.C.S. § 502(e)(1)(B).

Bankruptcy Law > Claims > Allowance

[HN3] No payment can be made to a principal creditor by one secondarily liable until liability has been determined.

Bankruptcy Law > Claims > Allowance
[HN4] Courts recognize the application of 11 U.S.C.S. § 502(e)(1)(B) to contractual claims for reimbursement, which remain contingent.

Bankruptcy Law > Claims > Allowance
Torts > Procedure > Multiple Defendants > Indemnity > Contractual Indemnity
[HN5] The phrase "an entity that is liable with the debtor" is broad enough to encompass any type of liability shared with the debtor, whatever its basis. Thus, 11 U.S.C.S. § 502(e)(1)(B) applies to claims other than contractual claims and clearly applies to contractual claims for indemnification.

Bankruptcy Law > Debtor Benefits & Duties > Debtor Duties
Contracts Law > Debtor & Creditor Relations
Securities Law > Initial Public Offerings & the Securities Act of 1933 > Underwriting Agreements
[HN6] Whether the duty to indemnify stemmed from an underwriting agreement or common law principles is "immaterial" because, in either case, the debtor would be affected in the same manner. If the underwriter and issuer were found liable in the underlying suit, the debtor's duty to indemnify the underwriter would come into effect independent of the underwriting agreement because of the joint and several liability established by federal statute in securities actions under 15 U.S.C.S § 77k(f).

Bankruptcy Law > Case Administration > Administrative Powers > Stays > Coverage > General Overview
Bankruptcy Law > Claims > Allowance
[HN7] The proper standard for determining if the claimant is liable with the debtor is whether the causes of action in the underlying lawsuit assert claims upon which, if proven, the debtor could be liable but for the automatic stay.

Bankruptcy Law > Claims > Allowance
[HN8] The determination of whether the claim is contingent is made at the time of the allowance or disallowance of the claim, which courts have established is the date of the ruling. The contingency contemplated by 11 U.S.C.S. § 502(e)(1)(B) relates to both payment and liability.

Civil Procedure > Joinder of Claims & Remedies > General Overview
[HN9] A contingent claim is by definition a claim which has not yet accrued and which is dependent upon some future event that may never happen.

Bankruptcy Law > Claims > Allowance
[HN10] One who is secondarily liable may only secure distribution rights by paying the amount owed the creditor.

Bankruptcy Law > Claims > Allowance
Bankruptcy Law > Claims > Reconsiderations
[HN11] The equities inherent in 11 U.S.C.S. § 502(e)(1)(B), however, are meant to benefit the debtor's direct creditors, not secondarily liable creditors with contingent claims. The degree of culpability of the respective parties is not an issue in the disallowance of claims under § 502(e)(1)(B).

Bankruptcy Law > Claims > Allowance
[HN12] The bankruptcy estate must not be burdened by estimated claims contingent in nature.

Bankruptcy Law > Claims > Types > Governmental Entities
Environmental Law > Hazardous Wastes & Toxic Substances > CERCLA & Superfund > Enforcement > Bankruptcy
Environmental Law > Hazardous Wastes & Toxic Substances > CERCLA & Superfund > Enforcement > Cost Recovery Actions > Potentially Responsible Parties > Owners & Operators
[HN13] Direct contingent claims are not excluded by 11 U.S.C.S. § 502(e)(1)(B).

Bankruptcy Law > Claims > Allowance
[HN14] If there is co-liability in the underlying action, then any amounts sought by way of indemnification or reimbursement "on account" of that underlying suit are subject to 11 U.S.C.S. § 502(e)(1)(B) objection.

Bankruptcy Law > Claims > Allowance
[HN15] In connection with pending third-party actions, 11 U.S.C.S. § 502(e)(1)(B) applies to claims for reimbursement of monies to be expended by the claimant in its defense of those underlying actions.

Bankruptcy Law > Claims > Allowance
[HN16] The interdependence between a claimant's defense costs and the underlying action for indemnification places all of the claimant's claims under the umbrella of 11 U.S.C.S. § 502(e)(1)(B).

Bankruptcy Law > Claims > Allowance
[HN17] 11 U.S.C.S. § 502(e)(1)(B) applies to whatever contingent claims a co-debtor has which entitle him to be made whole for monies he has expended on account of a debt for which he and the debtor are both liable.

Bankruptcy Law > Claims > Allowance
Contracts Law > Types of Contracts > Guaranty Contracts
[HN18] Although ordinarily the contingency mentioned in 11 U.S.C.S. § 502(e)(1)(B) relates to both payment and liability, the parties may contract to guarantee payment without regard to liability. Contractual liability simply nullifies the need for judicial determination of such liability.

Bankruptcy Law > Claims > Allowance
[HN19] A contingent claim becomes fixed and allowable to the extent that the co-debtor has paid the underlying claim.

Bankruptcy Law > Claims > Allowance
[HN20] Under 11 U.S.C.S. § 502(e)(2), a person secondarily liable with a debtor may fix the claim by payment to the principal creditor and the claim will be allowed and treated in the same manner as a pre-petition claim.

Bankruptcy Law > Claims > Allowance
[HN21] See 11 U.S.C.S. § 502(e)(2).

Bankruptcy Law > Claims > Allowance
Bankruptcy Law > Claims > Estimation
Bankruptcy Law > Claims > Reconsiderations
[HN22] Although 11 U.S.C.S. § 502(c) provides for the estimation of contingent claims, the section only applies to direct contingent claims because § 502(e)(1)(B) expressly provides for disallowance of contingent claims of a party secondarily liable with the debtor notwithstanding subsections (a), (b), and (c) of this section. 11 U.S.C.S. § 502(e)(1)(B). Although a creditor's claim which is contingent may give a right to estimation, a person secondarily liable to a creditor is not in the same position as the direct creditor. Thus, the claim may be estimated only if it is not disallowed by § 502(e)(1)(B).

Bankruptcy Law > Claims > Allowance
Bankruptcy Law > Claims > Estimation
[HN23] See 11 U.S.C.S. § 502(c).

Bankruptcy Law > Claims > Allowance
[HN24] Once the court establishes that an underwriter has a contractual right to indemnification from another underwriter without regard to its liability in the underlying litigation, to avoid the application of 11 U.S.C.S. § 502(e)(1)(B), the party seeking indemnification from the debtor must prove the amount of the debtor's share of the defense costs that it has already paid.

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JUDGES: Conrad *

* Sitting by Special Designation

OPINION BY: FRANCIS G. CONRAD

OPINION

[*983] MEMORANDUM OF DECISION ON THE APPLICATION OF [2] § 502(e)(1)(B) TO THE INDEMNIFICATION OF DEFENSE COSTS ASSOCIATED WITH UNRESOLVED UNDERLYING THIRD PARTY ACTIONS**

We are presented with two issues. [1] First, whether claims for indemnification of **[*984]** costs and expenses, including attorney fees, (Defense Costs) associated with the defense of unresolved underlying third-party actions in which the debtor and claimant are co-liable should be disallowed under 11 USC § 502(e)(1)(B). Second, whether the equities of the particular case before us constitute an exception to the general rule that contingent claims for indemnification on which the debtor and claimant are co-liable should be disallowed under § 502(e)(1)(B).

1 Our subject matter jurisdiction over this controversy arises under 28 USC § 1334(b) and the Order, dated February 19, 1991 (Pollack, S.D.J.), which withdrew the reference to this Court under 28 USC § 157(d) and 11 USC § 105(a), and simultaneously re-referred to us jurisdiction over all core and non-core related matters. This is a core matter under 28 USC §§ 157(b)(2)(A) and (B). This Memorandum of Decision constitutes findings of fact and conclusions of law under F.R.Civ.P. 52, as made applicable by F.R.Bkrtcy.P. 7052.

[3]** We hold that whether indemnification of Defense Costs associated with pending third-party actions should be disallowed depends upon the specific provisions of the parties' agreement. Further, we hold that the equities of the case before us do not constitute an exception to the general rule of disallowance of contingent claims under § 502(e)(1)(B).

FACTS

The Claimants filed proofs of claims relating to seven public offerings in 1986 of taxable municipal bonds (the "Offerings"). In connection with these Offerings, Drexel acted as the senior managing underwriter. The Claimants were underwriters in at least one Offering. The Claimants maintain that Drexel and the Claimants were parties to certain Agreements Among Underwriters (AAU's) that set forth the terms of their agreement, including the allocation of any costs or expenses associated with the Offerings.

The Claimants are defendants in various civil actions arising from the Offerings. Drexel is not named as a defendant in those actions only because the automatic stay came into effect when Drexel filed its bankruptcy petition. The civil actions allege that Drexel marketed $ 1.55 billion of taxable municipal bonds as safe, AAA **[**4]** rated securities when the bonds were backed by the "junk bond" market. Executive Life Insurance Company (ELIC), one of Drexel's "junk bond" customers, was to issue guaranteed investment contracts in which to invest the bond proceeds. It was anticipated that funds from these contracts would be disbursed for public purposes. The actions maintain that, although a portion of the proceeds of the Offerings was available for financing public purposes, it was known from the initial stages of the program that no loans would be made for public purposes and that bond proceeds would remain invested with ELIC. The plaintiffs in the civil actions allege that because of the excess junk bonds in ELIC's portfolio, the collapse of the junk bond market led to their losses. They seek a declaration that the bonds were void *ab initio,* and they seek damages of more than $ 1.55 billion.

The Claimants maintain that most of the allegations in the civil actions concern Drexel's willful misconduct and that the primary basis of liability alleged against the Claimants in the actions is on an agency theory based on Drexel's misconduct.

Drexel's portion of the underwritings in these Offerings ranged from 11.3% **[**5]** to 41%. The proportionate participation of the other underwriters average 2.76% to 4.46%.

The Claimants seek indemnification or reimbursement from Drexel because they allege that Drexel and the Claimants entered into AAU's under which each underwriter, including Drexel, is obligated to pay its proportionate share, based upon its participation in the Offerings, of Defense Costs of defending claims stemming from the Offerings. Drexel's bankruptcy has forced the Claimants to incur increased Defense Costs because of the *pro rata* reallocation to each Claimant of Drexel's proportion of each Offering. The Claimants want Drexel to indemnify them under each AAU for these increased Defense Costs. In addition, they maintain that under each AAU, Drexel is required to pay its proportionate share of any resultant judgment or settlement from those civil actions. Further, they argue that because of Drexel's bankruptcy, the other underwriters face the possibility of having to pay in excess of $ 1.55 billion for the alleged willful misconduct of their alleged agent, Drexel. Thus, they maintain that the equities dictate that their claims not be disallowed, but rather, that Drexel be obligated to **[**6]** pay its proportionate share of any judgment issued in the underlying action.

First Boston, Kidder, Advest, Prudential, Merrill Lynch, and Rothschild, (collectively, with Claimants, "Co-Underwriters") were co-underwriters with Drexel in various other underwritings of bond and equity security issues. Drexel acted as a co-lead underwriter in some of these offerings; in others, it was a member of the underwriting syndicate.

Similarly to the Claimants, these other co-underwriters are incurring Defense Costs associated with actions brought against the underwriters stemming from these bond and equity security offerings.

These co-underwriters seek indemnification from Drexel, under their respective AAU's, for the increased Defense Costs they have incurred because of the reallocation to each underwriter of Drexel's proportion of Defense Costs.

DISCUSSION

[HN1] The application of Code 11 USC § 502(e)(1)(B) [2] to disallow a claim requires that three elements be established. First, the claim must be for reimbursement or contribution. Second, the party asserting the claim must be "liable with the debtor" on the claim. Third, the claim must be contingent at the time **[**7]** of its allowance or disallowance. **In re Drexel Burnham Lambert Group, Inc.,** 146 Bankr. 98, 100-101 (Bkrtcy.S.D.N.Y. 1992). citing, **In re Provincetown-Boston Airlines, Inc.,** 72 Bankr. 307, 309 (Bkrtcy.M.D.Fla. 1987).

2 11 USC § 502(e)(1)(B) provides (in relevant part):

[HN2] The court shall disallow any claim for reimbursement or contribution of an entity that is liable with the debtor on, or has secured, the claim of a creditor, to the extent that -

. . .

(B) such claim for reimbursement or contribution is contingent as of the time of allowance or disallowance of such claim for reimbursement or contribution.

THE CLAIMANTS' INDEMNITY CLAIMS

In connection with the Claimants' request that Drexel pay its proportionate share of any future payment based on a judgment that may be made in the pending litigation with third parties, the first element for application of Code § 502(e)(1)(B) is met. The Claimants **[**8]** seek to be indemnified by Drexel for its share of any judgment issued in the underlying action and "the concept of reimbursement includes indemnity." **In re Wedtech Corp.,** 85 Bankr. 285, 289 (Bkrtcy.S.D.N.Y. 1988)**(Wedtech I).**

Claimants contend that the second element for application of § 502(e)(1)(B) is not met. Claimants maintain that § 502(e)(1)(B) is not applicable to their claims because the parties negotiated to reallocate the loss resulting from the Offerings and this bargained for reallocation, which was incorporated in their AAU, is irrespective of the parties' liability.

The fact that the AAU requires the reallocation of losses irrespective of each parties' individual liability, but rather based on their participation in the Offering, nevertheless requires that some liability be established against the parties. If no liability is established against the parties, the Claimants are not required to pay the plaintiffs in the underlying action and they have no claim against Drexel. [HN3] "No payment can be made to a principal creditor by one secondarily liable until liability has been determined." **[**9] In re Pacor Inc.,** 110 Bankr. 686, 689 (E.D.Pa. 1990). Further, [HN4] courts have always recognized the application of § 502(e)(1)(B) to contractual claims for reimbursement which remain contingent. This fact was acknowledged by the parties in **In re Baldwin-United Corp.,** 55 Bankr. 885, 890 **[*986]** (Bkrtcy.S.D.Ohio 1985). Indeed, in that case, in an effort to avoid the application of the section to a contribution claim of a joint tortfeasor, the parties argued that the section should be limited to contractual claims. In rejecting the limitation, the court noted that [HN5] the phrase "'an entity that is liable with the debtor' is broad enough to encompass any type of liability shared with the debtor, whatever its basis." **Baldwin-United, supra,** 55 Bankr. at 890. [3] Thus, the section applies to claims other than contractual claims, and clearly applies to contractual claims for indemnification.

3 The **Baldwin-United** court made reference to the fact that the legislative history to § 502(e) applied contract phrases to some of the types of claims intended. **Baldwin-United, supra,** 55 Bankr. 889 at 889-890 .

[10]** In **Provincetown-Boston,** an underwriter who was the defendant in an action alleging securities violations and fraud, sought indemnification from the issuer of the stock according to the terms of their underwriting agreement. The issuer, a bankruptcy debtor, objected to the claim under § 502(e)(1)(B) asserting that it was a claim for reimbursement by a party liable with the debtor and was contingent. The underwriter countered that its claim did not fall within the purview of § 502(e)(1)(B) because its claim stemmed from an "independent contractual obligation of [the issuer to the underwriter] established by [their] Underwriting Agreement." **Provincetown, supra,** 72 Bankr. at 309. The court was unpersuaded by this argument and found that [HN6] whether the duty to indemnify stemmed from an underwriting agreement or common law principles was "immaterial" because, in either case, the debtor would be affected in the same manner. The court added that, if the underwriter and issuer were found liable in the underlying suit, the debtor's duty to indemnify the underwriter would come into effect independent of the **[**11]** underwriting agreement because of the joint and several liability established by federal statute in securities actions under 15 USC § 77k(f). Thus, on facts similar to the case before us, the court found the underwriter and issuer satisfied the co-liability element.

The court commented that although the underwriter's claim was "based upon the express language of the Underwriting Agreement, the Underwriting Agreement [was] a contract for indemnification and contribution with respect to any liability arising from the issuance of [the issuer's] securities." **Provincetown, supra,** 72 Bankr. at 310. In the same manner, the AAU, in the case before us, provides for the underwriters to contribute their proportionate share of any resultant judgment in the underlying actions with respect to any liability stemming from the issuance of the bonds.

[HN7] The proper standard for determining if the claimant is liable with the debtor is whether "the causes of action in the underlying lawsuit assert claims upon which, if proven, the debtor could be liable but for the automatic stay." **In re Wedtech Corp,** 87 Bankr. 279, 284 (Bkrtcy.S.D.N.Y. 1988) **[**12] (Wedtech II),** citing, **Wedtech I, supra,** 85 Bankr. at 290. The indemnity claims stem from third-party claims against Drexel and the Claimants. Drexel would be a defendant in the actions commenced by the third parties but for the automatic stay. The actions are based on Drexel's co-liability with Claimants.

As noted in **Wedtech I,** part of the purpose of this section is administrative, to permit "distribution to unsecured creditors without a reserve for these types of contingent claims when the contingency may not occur until after the several years it often takes to litigate the underlying lawsuit." **Wedtech I, supra,** 85 Bankr. at 290. Thus, co-liability, the second element for the application of § 502(e)(1)(B) is established.

[HN8] The determination of whether the claim is contingent is made at the time of the allowance or disallowance of the claim, which courts have established is the date of the ruling. **Baldwin-United, supra,** 55 Bankr. at 894-

895. The contingency contemplated by § 502(e)(1)(B) relates to both payment and liability. **In re Pacor, supra,** 110 Bankr. at 689. **[**13]** The **Provincetown** court noted **[*987]** that [HN9] "a contingent claim is by definition a claim which has not yet accrued and which is dependent upon some future event that may never happen." **Provincetown, supra,** 72 Bankr. at 310. Similar to the facts of **Provincetown,** the future event yet to be established, in the case at bar, is a determination that Drexel and the Claimants' are liable in the civil actions. The Claimants' claim is contingent until their liability is established. **Id.,** and the co-debtor has paid the creditor. **Baldwin-United, supra,** 55 Bankr. at 895. [HN10] "One who is secondarily liable may only secure distribution rights by paying the amount owed the creditor." **Pacor, supra,** 110 at 690. The liability has not been determined in the underlying suit against the Claimants who are "liable with" Drexel, and payment has not been made to the plaintiff in the underlying action. Nor has there been any payment based on a settlement. [4] Thus, the claim is contingent. The three elements for the application of § 502(e)(1)(B) are satisfied inasmuch as this is a contingent claim for reimbursement on **[**14]** which the debtor and Claimants are co-liable.

4 This is not meant to imply that a settlement payment would eliminate the contingency. **See, In re Drexel Burnham Lambert Group Inc.,** 146 Bankr. 98 (Bkrtcy.S.D.N.Y. 1992), merely that, inasmuch as there has been no settlement payment made, we do not address the issue.

The Claimants further argue that even if they are liable with Drexel on contingent liabilities, the circumstances of this case requires that the claims not be disallowed. The Claimants maintain that the principal allegations in the underlying actions are based on Drexel's misconduct, that Drexel was the designer of the bond transactions and its primary consideration was generating fees. Most of the liability is asserted against Drexel, while the main theory of recovery against the Claimants is their authorization of Drexel to act as their agent. The Claimants contend that their inclusion as defendants is a result of Drexel's insolvency and they now face potential liability **[**15]** of $ 1.55 billion while Drexel, whom they label the primary wrongdoer, escapes liability. Although the Claimants recognize that contingent claims for reimbursement by a Claimant who is liable with the debtor on the claim are disallowed, they urge the application of the rule in this case is inequitable.

[HN11] The equities inherent in § 502(e)(1)(B), however, are meant to benefit the debtor's direct creditors, not secondarily liable creditors with contingent claims. The degree of culpability of the respective parties is not an issue in the disallowance of claims under § 502(e)(1)(B).

An important consideration is the need for finality in a bankruptcy proceeding. [HN12] The bankruptcy estate must not be burdened "by estimated claims contingent in nature." **In re Charter Company,** 862 F.2d 1500, 1502 (11th Cir. 1989). The goals of bankruptcy include the rehabilitation of the debtor by affording a fresh start while treating creditors fairly by "paying ascertainable claims as sickly as possible." **Id.** Policy considerations dictate that we reduce the required reserves that the debtor maintains while awaiting a resolution of contingencies. Moreover, we should provide **[**16]** for maximum initial and interim distributions to creditors with direct and ascertainable claims. The secondarily liable creditors should be given a lesser status.

"The purpose of disallowing contingent indemnity . . . claims is precisely because they are so contingent." **Wedtech, supra,** 85 Bankr. at 290. Indeed, the Claimants have moved to dismiss the underlying action and, if successful, the Claimants would have no liability to the underlying plaintiffs and thus, no claim against Drexel for reimbursement.

Further, we note the fact that Drexel has not escaped liability in the underlying action inasmuch as Drexel has paid with respect to those cases and others as part of the Securities Litigation Claims Settlement Agreement dated May 3, 1991. **In re Drexel Burnham Lambert Group, Inc.** 960 F.2d 285 (2d Cir. 1992)(affirming the District Court (MP) and the Bankruptcy Court (FGC), sitting jointly).

Accordingly, the Claimants' claim for indemnification of any future payment based **[*988]** on a judgment or settlement in a pending third-party action is disallowed.

CO-UNDERWRITERS INDEMNIFICATION CLAIMS FOR DEFENSE COSTS

The Co-Underwriters **[**17]** argue that claims for indemnification of Defense Costs are not within the scope of § 502(e)(1)(B) because the claims are not liabilities for which the Underwriters are "liable with" Drexel and the claims are not contingent.

The Co-Underwriters contend that there is no co-liability because while the Co-Underwriters owe fees to the attorneys in the third party actions, Drexel has no liability to these attorneys. Inasmuch as these attorneys could not proceed against Drexel to collect these amounts, the Co-Underwriters urge that the co-liability factor is not implicated.

The Co-Underwriters maintain that the legislative history to § 502(e)(1)(B) evinces the purpose of § 502(e)(1)(B) is to prevent "competition between a creditor and his guarantor for the limited proceeds in the [debtor's] estate." **In re A & H Inc.,** 122 Bankr. 84, 85 (Bkrtcy.W.D.Wis. 1990), **citing,** H.R. Rep. No. 95-575, 95th Cong., 1st Sess. 354 (1977), **reprinted in,** 1978 U.S. Code Cong. & Admin. News 5963, 6310. They argue that, because the attorneys are not creditors of Drexel, there is no threat of multiple liability and no need for the application of § 502 (e)(1)(B).

This narrow **[**18]** interpretation of § 502(e)(1)(B) based on the legislative history was rejected in **Wedtech I, supra,** 85 Bankr. 289 at 289-290 . Although the court noted that "a principal purpose of the entire subsection [§ 502(e)] is to prevent a double payment by the estate," § 502(e)(1)(B) was "not so limited." Rather, these contingent indemnification claims on which the parties are co-liable are disallowed because "they are so contingent." **Id. "Wedtech [I]** and a number of other courts have viewed § 502(e)(1)(B) as having purposes that reach beyond the risk to the debtor of double liability and are directed at the difficulty of administering and distributing the debtor's estate while ongoing contingent claims of the type covered by § 502(e)(1)(B) still exist." **Sorensen v. Drexel Burnham Lambert Group, Inc., (In re The Drexel Burnham Lambert Group, Inc.),** 146 Bankr. 92, 97 (S.D.N.Y. 1992).

The Underwriters cite **Al Tech Specialty Steel Corporation v. Allegheny International, Inc. (In re Allegheny International, Inc.),** 126 Bankr. 919 (W.D.Pa. 1991), to support their position that they are asserting a direct **[**19]** claim against Drexel. In **Allegheny,** the claimant sought reimbursement, under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), [5] from the previous owner of its steel plants for response costs to be incurred for the remediation of hazardous waste located at the plants. **Allegheny, supra,** 126 Bankr. at 921. The statute assesses liability against both the current owner of the property and any previous owner who owned the property at the time that hazardous materials were deposited on the property. After noting that [HN13] direct contingent claims are not excluded by § 502(e)(1)(B), **Id,** at 922, the court found that the CERCLA statute not only authorized "a joint-tortfeasor type contribution action for response costs incurred by a government entity" but also "a direct action for recovery of response costs incurred by a non-government entity." **Id.** at 922-923. The court reasoned that 42 USC § 9607(a)(4)(B)'s provision for a "direct action", removed the claimant's claim from **[*989]** the scope of § 502(e)(1)(B) because the claim did not involve liability **[**20]** owed to a third party, rather the debtor was directly liable to the claimant. **Id.** at 923.

5 42 USC § 9601 *et seq.* (1988). The section of CERCLA relied on by the claimants in Allegheny was 42 USC § 9607(a).

42 USC § 9607(a) provides in relevant part:

The owner and operator of a . . . facility, [and] any person who at the time of disposal of any hazardous substance owned or operated any facility at which, such hazardous substances were disposed of . . . shall be liable for

(A) all costs of removal or remedial action incurred by the United States Government or a State or an Indian tribe not inconsistent with the national contingency plan; [and]

(B) any other necessary costs of response incurred by any other person consistent with the national contingency plan[.]

In the case before us, no statute is implicated that would give the Underwriters a direct cause of action against Drexel. Thus, **Allegheny, [**21]** is inapposite.

Moreover, the **Allegheny** decision was recently criticized in **In re Cottonwood Canyon Land Co.,** Bankr. (Bkrtcy.D.Colo. 1992), 1992 WL 314329, as having been incorrectly decided. The **Cottonwood** court asserted that the claimant in **Allegheny** was clearly liable to the Environmental Protection Agency (EPA) with the debtor for remediation. The **Cottonwood** court insisted that this is demonstrated by the solution devised by the **Allegheny** court in response to the concern that the allowance of the claim might lead to multiple recoveries against the debtor. The debtor would be subject to multiple recovery if the claimant failed to take remedial action to remove the hazard after it had received a distribution from the debtor, leaving the debtor liable to a claim by the

Government for remediation of the plants. **Cottonwood, supra,** 1992 WL 314329 at 4. The **Allegheny** court's solution was to require that any distribution on the claim be placed in a trust and only released on remediation of the sites. **Allegheny, supra,** 126 Bankr. at 924. The **Cottonwood** court asserted that the "use of the trust device established **[**22]** the clear character of the claim." **Cottonwood, supra,** 1992 WL 314329 at 4. The claim was not a direct claim by the claimant. "Instead, the funds were to be placed in a trust so that they would be used to satisfy the obligation that both the debtor and the claimant had to the EPA for the remediation of the properties." **Id.** On facts similar to those involved in **Allegheny,** the **Cottonwood** court, under § 502(e)(1)(B), disallowed claims for future remediation costs.

As we previously noted, the co-liability factor is determined by reference to the underlying third party action. [HN14] If there is co-liability in the underlying action, then any amounts sought by way of indemnification or reimbursement "on account" of this underlying suit are subject to § 502(e)(1)(B) objection. **Wedtech II, supra,** 87 Bankr. at 287. The **Wedtech II** court found that, [HN15] in connection with pending third-party actions, § 502(e)(1)(B) applied to claims for reimbursement of "monies to be expended by [the claimant] in its defense" of those underlying actions. **Id.** Similarly, contingent claims for reimbursement of attorney fees associated with underlying actions in which **[**23]** the claimant was co-liable with the debtor were disallowed in **Wedtech I, supra,** 85 Bankr. at 288-290 and in **Sorenson v. Drexel, supra,** 146 Bankr. at 97. [HN16] "The interdependence between [the claimant's] defense costs and the underlying action for indemnification places all of [the claimant's] claims under the umbrella of § 502(e)(1)(B)." **Id.**

These Underwriter's Defense Costs arise as a result of the underlying litigations in which Drexel and the Claimants are co-liable. Section 502(e)(1)(B) [HN17] applies to "whatever contingent claims a co-debtor has which entitle him to be made whole for monies he has expended *on account* of a debt for which he and the debtor are both liable." **Wedtech II, supra,** 87 Bankr. at 287, (emphasis added). Thus, the Underwriters' claims for indemnification of Defense Costs are claims for reimbursement on which the claimant is "liable with the debtor."

The only factor that remains to be determined is whether the contingency has been eliminated. The Underwriters urge that the payments that have been made to the attorneys representing them in the third party actions eliminate **[**24]** that contingency insofar as payments have been made. Drexel contends that the contingency has not been eliminated because there must be a finding of good faith on the part of the Underwriters in the underlying suit before Drexel is required to reimburse them. Absent this determination, Drexel continues, the contingency is not removed and the parties claim is subject to disallowance under § 502(e)(1)(B).

The Underwriters counter that there is no requirement in their respective AAU's for a finding of good faith on the part of the Underwriters. Rather, they allege that **[*990]** the terms of the agreements require that Drexel indemnify the Underwriters for any amounts expended in the defense of these third-party actions without regard to any finding of good faith. The Underwriters, therefore, maintain that when they paid the Defense Costs, this fixed the amounts due and eliminated any contingency. Further, that under § 502(e)(2), to the extent their claims have become fixed by payment, the claims should be allowed and treated in the same manner as pre-petition claims.

Drexel argues that where there are ongoing third-party actions, everything, including the Defense Costs, is contingent with respect **[**25]** to a potential judgment. The contingency continues until the underlying actions are concluded and the merits are determined. In support of this position, Drexel relies on **Wedtech I,** where former officers and directors of the corporation sought indemnification for their defense costs arising from pending litigation and the court found those claims remained contingent until a determination with respect to liability in the underlying suit. In **Wedtech I,** however, the claims for indemnification sought by the former officers and directors were rooted in **Wedtech's** bylaws which provided for indemnification of the officers and directors only if they had acted in good faith or were successful on the merits. The claim for indemnification remained contingent until the conclusion of the underlying lawsuit that would determine the officers or directors good faith or whether they were successful on the merits.

The Co-Underwriters maintain that under their respective AAU's, their claims are not dependent on the outcome of the underlying litigations. Rather, Drexel is obligated to indemnify them regardless of the outcome of the underlying actions. They allege that the AAU's provide that **[**26]** each underwriter would pay Defense Costs based on its percentage participation in the particular bond issues irrespective of any underlying liability in the actions.

[HN18] Although, ordinarily "the contingency relates to both payment and liability," **Pacor, supra,** 110 Bankr. at 689, the parties may contract to guarantee payment without regard to liability. "Contractual liability simply nullifies the need for judicial determination of such liability." **Id.** Thus, if the AAU's provide that Drexel will pay its

proportionate share of the Defense Costs irrespective of any liability, a determination of liability is not in issue. The only contingency with respect to Drexel's share of the Defense Costs, that have already been incurred, relates to their payment. [HN19] A contingent claim becomes fixed and allowable to the extent that the co-debtor has paid the underlying claim. **In re Early & Daniel Industries, Inc.,** 104 Bankr. 963, 966 (Bkrtcy.S.D.Ind. 1989). [HN20] Under § 502(e)(2), [6] a person secondarily liable with a debtor may fix the claim by payment to the principal creditor and the claim will be allowed and treated in the same manner as **[**27]** a pre-petition claim. **Pacor, supra,** 110 Bankr. at 689.

6 11 USC § 502(e)(2) provides in relevant part:

[HN21] A claim for reimbursement or contribution of [an entity that is liable with the debtor on, or has secured, the claim of a creditor] that becomes fixed after the commencement of the case shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section, or disallowed under subsection (d) of this section, the same as if such claim had become fixed before the date of the filing of the petition.

We must look to the language of each AAU to determine whether Drexel agreed to pay a share of Defense Costs based only on its proportionate share of the Offering. Where Drexel entered into this guarantee, to the extent that the Co-Underwriters have paid Drexel's share of the Defense Costs that have already been incurred, they have established their right to payment. **Early & Daniel, supra,** 104 Bankr. at 967. As **[**28]** of the date of the ruling on the objection, the date of this Memorandum of Decision, their claim is not contingent and will be allowed.

Prior to reviewing the language of the respective AAU's submitted by the Co-Underwriters, we address the Co-Underwriters request that this court not disallow the future Defense Costs, but rather, estimate **[*991]** them under § 502(c). [7] We have already ruled that the Co-Underwriters claims for indemnification of the Defense Costs satisfy the requirement that the Co-Underwriters are "liable with" Drexel for the Defense Costs because they stem from underlying actions on which Drexel and the Co-Underwriters are co-liable. Thus, to the extent these Defense Costs are not determined and remain unpaid, they are contingent claims for indemnification of a party co-liable with the debtor and disallowed under § 502(e)(1)(B). [HN22] Although § 502(c) provides for the estimation of contingent claims, the section only applies to direct contingent claims because § 502(e)(1)(B) expressly provides for disallowance of contingent claims of a party secondarily liable with the **[**29]** debtor "notwithstanding subsections (a), (b), and (c) of this section." 11 USC § 502(e)(1)(B). Although a creditor's claim which is contingent may give a right to estimation, "a person secondarily liable to a creditor is not in the same position as the [direct] creditor." **Pacor, supra,** 110 Bankr. at 690. Thus, the claim may be estimated only if it is not disallowed by § 502(e)(1)(B). The Co-Underwriters claims for future Defense Costs are disallowed, subject to their right to have the disallowed claim reconsidered, under Code § 502(j), "if the contingency is resolved", **Sorenson v. Drexel, supra,** 146 Bankr. at 94, by future payments.

7 11 USC § 502(c) provides in relevant part:

[HN23] There shall be estimated for purpose of allowance under this section-

(1) any contingent or unliquidated claim, the fixing or liquidation of which, as the case may be, would unduly delay the administration of the case[.]

[30]** THE AAU'S

Each party was directed to submit a copy of the AAU associated with the offering for which they seek reimbursement of Defense Costs which have already been incurred.

The First Boston AAU provides for each underwriter involved in the offering to pay its proportionate share, based on its participation in the offering, "of any legal expenses reasonably incurred . . . in connection with investigating or defending any [action stemming from the offering]." First Boston Adams County Colorado Bond AAU, P 13, dated November 6, 1986.

The agreement to pay the costs of defending the action is not dependent on the outcome of the underlying action.

Paragraph 13 of The First Boston AAU further provides that "each non-defaulting Underwriter shall be obligated to

pay its proportionate share of all defaulted payments, based upon such Underwriter's participation in the Bonds as related to the participations in the Bonds of all non-defaulting Underwriters."

Paragraph 11 of The First Boston AAU provides that "nothing [in the AAU] will relieve a defaulting Underwriter from liability for its default."

In the same way, the AAU's associated with the offerings underwritten by Merrill Lynch, **[**31]** Advest, and Shearson Lehman all provide for each underwriter to pay its proportionate share of any Defense Costs without regard to one underwriter's liability in relation to another's liability. [8] These indemnification sections of the AAU's also all provide for the reallocation to non-defaulting underwriters of the obligations of defaulting underwriters. The sections also provide that defaulting underwriters are not relieved from liability.

8 Merrill Lynch, Master AAU regarding Finevest Securities litigation, Section 19.

Merrill Lynch, AAU with reference to The One Bancorp. Section 18.

Merrill Lynch, Master AAU with reference to Home Shopping Network litigation, Section 19.

Advest and Shearson Lehman, AAU with reference to lies Department Stores, Section 18(b).

First Boston, Advest, Merrill Lynch, and Shearson Lehman all have a contractual basis for the payment of Defense Costs, irrespective of the parties' liability *vis a vis* each other.

[HN24] Once we establish that an underwriter has this contractual right **[**32]** to indemnification from another underwriter without regard to its liability in the underlying litigation, **[*992]** to avoid the application of § 502(e)(1)(B), the party seeking indemnification from the debtor must prove the amount of Drexel's share of the Defense Costs that it has already paid.

The non-defaulting underwriters may not collect from Drexel any amounts that would be reallocated to Drexel under the AAU because of another underwriter's default. According to the AAU, a defaulting underwriter is not relieved from liability for its default. Thus, the non-defaulting underwriters have an action against any defaulting underwriter for its share of Defense Costs, and the amount Drexel owes for its share of these increased Defense Costs due to another underwriter's default remains contingent until any action against this other non-defaulting underwriter is resolved. The non-defaulting underwriters must pay the share of Defense costs that would be reallocated to Drexel because of another underwriter's default.

Thus, each underwriter must pay its share of Defense Costs and its share of the amount that would have been reallocated to Drexel because of another underwriters **[**33]** default before any portion of the payments it makes for Defense Costs is attributable to being a payment of Drexel's share.

To the extent of any payments for Drexel's share, the contingency is eliminated and the claim is allowable.

First Boston, Shearson Lehman, Advest and Merrill Lynch all have a contractual basis for indemnification of the Defense Costs without regard to the outcome of the underlying litigation. To the extent they have paid Drexel's share, their claim is allowed.

Kidder seeks indemnification for Defense Costs associated with actions stemming from three offerings. For the first, no AAU was provided to the court and the claim is disallowed.

The AAU filed with the court in support of the First Executive offering has no provision related to indemnification of one underwriter by another. The only indemnification provided for in the AAU flows from the issuer, First Executive, to the underwriters or from the underwriters to the issuer. Thus, there is no contractual basis for indemnification among underwriters. The underwriters' claim for indemnification from Drexel must await adjudication of the underlying action before they may bring actions for contribution against **[**34]** Drexel. The claim remains contingent and is disallowed.

Kidder seeks indemnification for Defense Costs associated with actions stemming from the Wyoming Community Development offering. The AAU provided to the court, in support of this request, provides for indemnification from

co-underwriters based on the underwriter's proportionate share of the offering, independent of the underlying action. To the extent of any payments made by the Co-Underwriters for Drexel's share of Defense Costs, the claim is allowed.

Rothschild did not submit a copy of its AAU or any documentation to support its claim. Rothschild's claim is disallowed.

The Claimants and Prudential [9] have not submitted executed copies of the AAU's upon which they base their claim for indemnification of Defense Costs. The Claimants contend that Drexel, who was lead underwriter, executed the AAU's on their behalf and should have a copy of the documents.

9 Prudential's interests are represented by the Claimants.

Claimant's submitted a standard form AAU that **[**35]** was used by Drexel during the relevant time period, and copies of telexes with respect to each offering sent by Drexel to Howard Weil, one of the Claimants. With respect to each offering, a telex was sent by Drexel to Howard Weil informing them that its participation in the offering was subject to the relevant AAU "whether or not [it had] executed and returned such agreement." Another telex was sent that indicates that Drexel will execute the relevant AAU on Howard Weil's behalf at a time certain unless it receives, "prior to that time[,] a telegram or telex revoking [Howard Weil's] power-of-attorney."

[*993] Drexel denies the standard AAU is the applicable AAU and claims it has not found the relevant AAU's in its records. Drexel did, however, find unexecuted copies of AAU's with respect to two offerings.

At a July 9, 1992 hearing before this court, with respect to a motion filed by the Claimants to compel production of documents by Drexel, counsel for the Claimants requested the opportunity to depose Drexel's custodian of records. The court left open the option for claimants to take testimony in court if they were not satisfied with the results of the deposition. Another hearing is required **[**36]** to afford the Claimants the opportunity for further discovery to locate the relevant documents.

CONCLUSION

The Claimants request for indemnification by Drexel of its proportionate share of any future payment, based on a judgment or settlement, that may be made in pending litigation is disallowed under § 502(e)(1)(B), as a contingent, indemnity claim on which the debtor and Claimants are co-liable. Further, the equities of the case before us do not constitute an exception to this rule of disallowance.

The First Boston, Merrill Lynch, Advest and Shearson Lehman AAU's submitted to the court all provide a contractual basis for indemnification of Defense Costs. To the extent of any payments made by the Co-Underwriter's for Drexel's share of Defense Costs, their claim is allowed.

Kidder has a contractual basis for indemnification of Defense Costs based on its Wyoming Community Development Offering AAU. To the extent of any payments made by the Co-Underwriters for Drexel's share of Defense Costs, their claim is allowed.

Kidder's claim for indemnification, based on the First Executive AAU, does not provide a contractual basis for indemnification among the **[**37]** underwriters. They must await adjudication of the underlying action before they may bring actions for contribution from Drexel. The claim is disallowed.

Rothschild and Kidder claims based on offerings where no AAU was submitted to the court are disallowed.

Claimants will be afforded an opportunity for further discovery to locate the relevant AAU's in relation to their claim for Defense Costs.

Counsel for Debtor to settle the order.

Dated at New York, New York, this 18th day of December, 1992.

Francis G. Conrad

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

AND IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF SINO-FOREST CORPORATION

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

Court of Appeal File No. C56125
Superior Court File No. CV-12-9667-00CL

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