Court File No. CV-12-9667-00CL

ONTARIO

SUPERIOR COURT OF JUSTICE

COMMERCIAL LIST

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

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

BOOK OF AUTHORITIES OF THE APPLICANT SINO-FOREST CORPORATION

(Motion Regarding the Status of Shareholder Claims and Related Indemnity Claims under the CCAA, Returnable June 26, 2012)

Dated: June 22, 2012

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Tab 1

Indexed as:

Blue Range Resource Corp. (Re)

IN THE MATTER OF The Companies' Creditors Arrangement Act, R.S.C. 1985, C. C-36, as amended AND IN THE MATTER OF Blue Range Resource Corporation

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Action No. 9901-04070

Alberta Court of Queen's Bench
Judicial District of Calgary

Romaine J.

Judgment: filed January 10, 2000.

(84 paras.)

Counsel:

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

REASONS FOR JUDGMENT

ROMAINE J.:--

INTRODUCTION

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

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

FACTS

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

(a) it purchased shares of Blue Range for cash through The Toronto Stock Exchange on October 27 and 29, 1998;
(b) it undertook a hostile takeover bid on November 13, 1998, by which it sought to acquire all of the issued and outstanding Blue Range shares;
(c) it paid for the Blue Range shares sought through the takeover bid by way of a share exchange: Blue Range shareholders accepting Big Bear's offer received 11 Big Bear shares for each Blue Range share;
(d) it issued Big Bear shares from treasury to provide the shares used in the share exchange.

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

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

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

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

(a) all claims of any nature must be proved by filing with the Monitor a Notice of Claim with supporting documentation, and
(b) claims not received by the Monitor by May 7, 1999, or not proved in accordance with the prescribed procedures, are forever barred and extinguished.

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

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

(a) a declaration that the unsecured claim of Big Bear is a meritorious claim against Blue Range; and
(b) an order directing the expeditious trial and determination of the issues raised by the unsecured claim of Big Bear.

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

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

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

ISSUE #1

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

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

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

Summary of Decision

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

Analysis

15 The position of the Applicants is that the share exchange itself was clearly an investment in capital, and that the claim for the share exchange loss derives solely from and is inextricably intertwined with Big Bear's interest as a shareholder of Blue Range. The Applicants submit that there are therefore good policy reasons why the claim should rank after the claims of unsecured creditors of Blue Range, and that basic corporate principles, fairness and American case law support these policy reasons. Big Bear submits that its claim is a tort claim, allowable under the CCAA, and that there is no good reason to rank the claim other than equally with unsecured creditors. Big Bear submits that the American cases cited are inappropriate to a Canadian CCAA proceeding, as they are inconsistent with Canadian law.

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

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

18 There is no doubt that Big Bear has exercised its rights as a shareholder of Blue Range. Pursuant to the Unanimous Shareholders' Agreement, it authorized Blue Range to file an application under the CCAA "to attempt to preserve the equity value of [Blue Range] for the benefit of the sole shareholder of [Blue Range]" (Bourchier

November 1, 1999 affidavit). It now attempts to recover its alleged share exchange loss through the claims approval process and rank with unsecured creditors on its claim. The issue is whether this is a collateral attempt to obtain a return on an investment in equity through equal status with ordinary creditors that could not be accomplished through its status as a shareholder.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

49 Big Bear submits that ascribing some legal impediment to a shareholder pursuing a remedy in tort against a company in which it holds shares violates the principle set out in Salomon v. Salomon and Company, Limited [1897] A.C. 22 (H.L.) that corporations are separate and distinct entities from their shareholders. In my view, this is not in issue. What is being sought here is not to limit a tort action by a shareholder against a corporation but to subordinate claims made qua shareholder to claims made by creditors in an insolvency situation. That shareholder rights with respect to claims against a corporation are not unlimited has already been established by the cases on rescission and recognized by statutory limitations on redemption and retraction. In this case, the

issue is not the right to assert the claim, but the right to rank with creditors in the distribution of the proceeds of a pool of assets that will be insufficient to cover all claims. No piercing of the corporate veil is being suggested or would result.

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

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

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

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

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

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

56 The three American cases decided on this direct issue before the 1978 statutory codification of the law of equitable subordination are not based on a doctrine of American law that is inconsistent with or foreign to Canadian common law. It is not necessary to adopt the U.S. absolute priority rule to follow the approach they espouse, which is based on equitable principles of fairness and policy. There is no principled reason to disregard

the approach set out in these cases, which have application to Canadian business and economy, and I have found them useful in considering this issue.

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

ISSUE #2

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

Summary of Decision

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

Analysis

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

61 The Applicants argue that Big Bear did not suffer any damages arising from the share exchange. The Big Bear shares used in the share exchange came from treasury: Big Bear did not use any corporate funds or corporate assets to purchase the Blue Range shares. As the shares used in the exchange did not exist prior to the transaction, Big Bear was essentially in the same financial position pre-issuance as it was post-issuance in terms of its assets and liabilities. The nature and composition of Big Bear's assets did not change as the treasury shares were created and issued for the sole purpose of the share exchange. Therefore, Big Bear did not sustain a loss in the amount of the value of the shares. The Applicants submit that the only potential loss is that of the pre-takeover shareholders of Big Bear, as the value of their shares may have been diluted as a result of the share exchange. However, even if there was such a loss, Big Bear is not the proper party to pursue such an action. Just as shareholders may not bring an action for a loss which properly belongs to the corporation, a corporation may not bring an action for a loss directly incurred by its shareholders.

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

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

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

65 Big Bear's claim is in tort, not contract. This is an important distinction, as the issue at hand concerns the

measure of damages. The measure of damages is not necessarily the same in contract as it is in tort.

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

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

> The English and Canadian cases have consistently held that the proper measure [with respect to fraudulent misrepresentation] is the tortious measure, that is the amount of money required to put the plaintiff in the position that would have been occupied not if the statement had been true but if the statement had not been made. The point was made clearly in McConnel v. Wright , [1903] 1 Ch. 546 (C.A.):
>
>> It is not an action for breach of contract, and, therefore, no damages in respect of prospective gains which the person contracting was entitled by his contract to expect come in, but it is an action of tort - it is an action for a wrong done whereby the plaintiff was tricked out of certain money in his pocket; and therefore, prima facie, the highest limit of his damages is the whole extent of his loss, and that loss is measured by the money which was in his pocket and is now in the pocket of the company. That is the ultimate, final, highest standard of his loss. (at 5-19, 5-20)
>
> ...
>
> Since the decision of the House of Lords in 1963 in Hedley Byrne Ltd. v. Heller & Partners Ltd., [1964] A.C. 465 (H.L.) it has been established that an action lies for negligent misrepresentation causing economic loss. It naturally follows from acceptance of out-of pocket loss rather than the contractual measure as the basic measure of damages for fraud, that the same basic measure applies to negligent misrepresentation. (at 5-28).

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

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

70 That Big Bear has not incurred a loss in the face value of the exchanged shares is demonstrated by comparing the existing facts with hypothetical situations in which such a loss may be found. Had Big Bear been required to pay for the shares used in the exchange, for instance, by purchasing shares from existing Big Bear

shareholders, there would have been a clear loss of funds evidenced in the Big Bear financial statements. Big Bear's financial position prior to the exchange would have been significantly better than its position afterwards. However, no such difference results from the mere exchange of newly-issued shares. If there had been evidence that Big Bear was or could be compelled to redeem or retract the new shares at the value assigned to them at the time of the share exchange, Big Bear may have a loss in the amount of the exchange value of the shares. However, there is no evidence of such a redemption or retraction feature attaching to these shares.

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

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

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

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

ISSUE #3

74a Is Big Bear entitled to make or advance by way of argument in these proceedings the claims represented by the heads of damage specified in the draft Statement of Claim set out at Exhibit "F" to the affidavit of A. Jeffrey Tonken dated June 25, 1999?

[The Court did not paragraph number Issue #3. Quicklaw has assigned the number 74a.]

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

Summary of Decision

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

Analysis

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

in this case, the form used for the "Notice of Claim" was not approved by any order of the court. At any rate, Big Bear submits that it is not seeking to amend its claim to add new claims or to claim additional amounts.

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

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

80 In summary, Big Bear asks that the court direct an expedited trial for the hearing of its claim as outlined in the draft Statement of Claim.

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

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

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

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

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

84 I note that LoVecchio, J. issued a judgment after this application was heard relating to claims for relief from the impact of the claims procedure established by the court by a number of creditors who filed late or wished to amend their claims after the claims bar date of May 7, 1999 had passed. Although LoVecchio, J. allowed these claims, and found that it was appropriate in the circumstances to grant flexibility with respect to the applications before him, he noted that total amount of the applications made to him would be less than 1.4 million dollars, and the impact of allowing the applications was minimal to the remaining creditors. The applications before him do not appear to involve issues which had been the subject of previous court orders, as in the current situation, nor would they have the same implication to creditors as would Big Bear's claim. The decision of LoVecchio, J. in the circumstances of the applications before him is distinguishable from this issue.

ROMAINE J.

cp/i/qljpn

Tab 2

COURT FILE NO.: 04-CL-5306
DATE: 20060120

SUPERIOR COURT OF JUSTICE - ONTARIO
(Commercial List)

2006 CanLII 1773 (ON SC)

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 PROPOSED PLAN OF COMPROMISE OR ARRANGEMENT WITH RESPECT TO STELCO INC. AND THE OTHER APPLICANTS LISTED IN SCHEDULE "A"

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

BEFORE: FARLEY J.

COUNSEL: Michael Barrack, James D. Gage and Geoff R. Hall, for the Applicants
Robert Thornton and Kyla Mahar, for the Monitor
Peter Jervis, George Glezos and Karen Kiang, for the Equity Holders
John Varley, for the Salaried Employees
David Jacobs, for USW Locals 8782 and 5328
Aubrey Kauffman, for Tricap Management Ltd.
Kevin Zych and Rick Orzy, for the 8% and 10.4% Stelco Bondholders
Lawrence Thacker, for the Directors of Stelco
Sharon White, for USW Local 1005
Ken Rosenberg, for USW International
Kevin McElcheran, for GE
Gale Rubenstein and Fred Myers, for the Superintendent of Financial Services
Derrick Tay, for Mittal
David R. Byers and Sean Dunphy, for CIT Business Credit as DIP and ABL Lender
V. Gauthier, for BABC Global Finance
L. Edwards, for EDS Canada Inc.
Peter Jacobsen, for Globe & Mail
Paul Macdonald and Andy Kent, for Sunrise and Appalloosa
Murray Gold and Andrew Hatnay, for the Salaried Retirees
Flaviano Stanc, Self-Represented

HEARD: January 17-18, 2006, with further information January 20, 2006

ENDORSEMENT

(Motion by the Applicants for a Sanction Order and Cross-Motion of Certain Equity Holders)

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[1] The Applicants (collectively "Stelco") moved for:

(a) a declaration that Stelco has complied with the provisions of the *Companies' Creditors Arrangement Act* ("CCAA") and the orders of this court made in this CCAA proceeding;

(b) a declaration that the Stelco plan of arrangement pursuant to the CCAA and the reorganization of Stelco Inc. ("S") under the *Canada Business Corporations Act* ("CBCA") (collectively the "Plan") as voted on by the affected creditors of Stelco is fair and reasonable;

(c) an order sanctioning and approving the Plan; and

(d) an order extending the Stay Period and Stay Date in the Initial Order until March 31, 2006.

[2] This relief was unopposed by any of the stakeholders except for various existing shareholders of S (who may also be employees or retirees of Stelco). In particular there was organized objection to the Plan, especially as in essence the Plan would eliminate the existing shareholders, by a group of shareholders (AGF Management Ltd., Stephen Stow, Pollitt & Co., Levi Giesbrecht, Joe Falco and Phil Dawson) who have styled themselves as "The Equity Holders" ("EH"). On December 23, 2005 the EH brought in essence a cross motion seeking the following relief:

(a) An order extending the powers of the Monitor, Ernst & Young, in order to conduct a sale of the entire Stelco enterprise as a going concern through a sale of the common shares or assets of Stelco on such terms and conditions as are considered fair;

(b) An order authorizing and directing the Monitor to implement and to take all steps necessary to complete and fulfill all requirements, terms, conditions and steps of such a sale;

(c) An order authorizing and directing the Monitor to conduct the sale process in accordance with a plan for the sale process approved by the court;

(d) An order directing the Monitor to retain such fully independent financial advisors and other advisors as necessary to conduct this sale process;

(e) An order confirming that the powers granted herein to the Monitor supersede any provision of any prior Order of this Court made in the within proceedings to the extent that such provision of any prior order is inconsistent with or contradictory to this order, or would otherwise limit or hinder the power and authority granted to the Monitor;

(f) An order directing Stelco and its directors, officers, counsel, agents, professional advisors and employees, and its Chief Restructuring Officer, to cooperate fully with the Monitor with regard to this sale process, and to provide the Monitor with such assistance as may be requested by the Monitor or its independent advisors;

(g) In the alternative, an order suspending the sanctioning of the Proposed Plan of Arrangement, approved by the creditors on December 9, 2005, for a period of two months from the date of such order, so that the Monitor may conduct the independent sale process that may result in a more profitable outcome for all stakeholders, including the Equity Holders;

(h) In the further alternative, an order lifting the *Companies' Creditors Arrangement Act* stay of proceedings in respect of Stelco without approving the Plan of Arrangement, as approved by the creditors on December 9, 2005, pursuant to such terms as are just and are directed by court; and

(i) Such further and other relief as counsel may advise and this Honourable Court may permit.

[3] In its factum, the EH requested that the court adjourn approval of the Plan for 60 days and direct the Monitor to conduct an independent sale process for the shares of S. In the attendances on January 17 and 18, 2006, the EH then asked that approval of the Plan be adjourned for 30 days in order to see if there were expressions of interest for the shares of S forthcoming in the interim.

[4] I indicated that I would defer my consideration of the adjournment request until after I had had submissions on the motions before me as set out above. I also indicated that while there did not appear to be any concern by anyone including the EH as to the first two elements concerning CCAA plan sanctioning as discussed in *Re Algoma Steel Inc.* (2001), 30 C.B.R. (4th) 1 (Ont. S.C.J.) at p. 3:

> In a sanction hearing under the *Companies' Creditors Arrangement Act* ("CCAA") the general principles to be applied in the exercise of the court's discretion are:
>
> (a) There must be strict compliance with all statutory requirements and adherence to the previous orders of the court;

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> (b) All materials filed and procedures carried out must be examined to determine if anything has been done or purported to be done which is not authorized by the CCAA; and
>
> (c) The Plan must be fair and reasonable.
>
> See *Northland Properties Ltd., Re* (1988), 73 C.B.R. (N.S.) 175 (B.C. S.C.), affirmed *Northland Properties Ltd. v. Excelsior Life Insurance Co. of Canada* (1989), 73 C.B.R. (N.S.) 195 (B.C. C.A.) at p. 201; *Campeau Corp., Re* (1992), 10 C.B.R. (3d) 104 (Ont. Gen. Div.) at p. 109; *Olympia & York Developments Ltd. v. Royal Trust Co.* (1993), 12 O.R. (3d) 500 (Ont. Gen. Div.) at p. 506; *Sammi Atlas Inc., Re* (1998), 3 C.B.R. (4th) 171 (Ont. Gen. Div. [Commercial List]), at pp. 172-3; *Canadian Airlines Corp., Re*, [2000] 10 W.W.R. 269 (Alta. Q.B.), leave to appeal dismissed, [2000] 10 W.W.R. 314 (Alta. C.A. [In Chambers]).

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it would not be sufficient to only deal in this hearing with the third test of whether the Plan was fair and reasonable (including the aspect of "fair, reasonable and equitable" as discussed in *Sammi*). Rather the court also had to be concerned as to whether the Plan was implementable. In other words, it would be futile and useless for the court to approve a plan which stood no reasonable prospect of being implemented. That concern of the court had been raised by my having been alerted by the Monitor in its 46th Report at paragraphs 8-9:

> 8. The Monitor has had discussions with the proposed ABL lenders, Tricap, the Province and Stelco regarding the status of the ABL Loan and the Bridge Loan. The Monitor has been advised that the parties are continuing to work at resolving issues that are outstanding as at the date of this Forty-Sixth Report. However, all of the parties remain optimistic that acceptable solutions to the outstanding issues will be found and implemented.
>
> 9. In the Monitor's view, the principal issues to be resolved include:
>
> (a) the corporate structure of Stelco, which could involve the transfer of assets of some of the operations or divisions of the Applicants to new affiliates; and
>
> (b) satisfying the ABL lenders and Tricap as to the priority of the new financing.
>
> These issues need to be resolved primarily among the proposed ABL lenders, Tricap and Stelco and will also involve the Province insofar as they affect pension and related liabilities.

[5] I was particularly disquieted by the lack of progress in dealing with these outstanding matters despite the passage of 39 days since the Plan was positively voted on December 9, 2005. I do appreciate that Christmas, Hanukkah and New Year's were celebrated in this interval and that there had been a certain "negotiation fatigue" leading up to the December 9th revisions to the Plan and that I have advocated that counsel, other professionals and litigation participants balance their lives and pay particular attention to family and health. However I find it unfortunate that there would appear to have been such a lengthy hiatus, especially when the workers at Stelco continued (as they have for the past two years while Stelco has been under CCAA protection) to produce steel in record amounts. I therefore demanded that evidence be produced forthwith to demonstrate to my satisfaction that progress was real and substantial so that I could be satisfied about implementability. As a side note I would observe that in the "normal" case, sanction orders are typically sought within two or three days of a positive creditor vote so that it is not unusual for documentation to be sorted out for a month before a plan is implemented with a closing.

[6] The EH filed material to support its submission that the Plan is not fair, reasonable and equitable because it is alleged that there is currently sufficient value in Stelco to fully satisfy the claims of affected and unaffected creditors and to provide at least some value to current shareholders. The EH prefers to have a search for some entity to take out the current shareholders for "value". Fabrice Taylor, a chartered financial analyst with Pollit & Co. swore an affidavit on the eve of this hearing which was sent electronically to the service list on January 16, 2006 at approximately 7:30 p.m. In that affidavit, he states:

> 2. The Dofasco bidding war has highlighted a crucial fact about steel asset valuations, notably that strategic buyers place a much higher value on them than public market investors. Attached as Exhibit "1" is an article entitled "Restructuring of steel industry revives investors' interest", published in the Financial Times on December 14, 2005.
>
> 3. I, along with Murray Pollitt and a number of Stelco shareholders, have spent the past three months attempting to attract strategic buyers and/or equity investors in Stelco. These strategic buyers and equity investors are mostly international. Some had already considered buying Stelco or had made bids for the company but had stopped following the story some months ago. Others were not very familiar with Stelco.
>
> 4. Three factors hindered our efforts. First, Stelco is under CCAA protection, a complicated situation involving multiple players and interests (unions, politics, pensions) that is difficult to understand, particularly for foreigners. Second, there has not been enough time for these strategic buyers or equity investors to deepen their understanding or to perform due diligence. Finally, the Dofasco bid process, while providing emphatic evidence that steel assets are increasingly valuable, hinders certain strategic buyers and financial

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institutions interested in participating in Stelco because they are distracted and/or conflicted by the Dofasco sale. I have been advised by some of the participants in the Dofasco negotiations that they would be willing to carefully consider a Stelco transaction once the Dofasco sale has been resolved.

5. The Forty Fifth Report of the Monitor confirmed that Stelco had not received any offers in the last several months. The report does not answer the question of whether the company or its financial advisors have in fact attempted to attract any offers. I believe that Stelco would have received expressions of interest had the company made efforts to attract offers, or had the Dofasco sale been resolved earlier. I believe that the Monitor should be authorized, for a period of at least 60 days, to canvas interest in a sale of Stelco before the approval of the proposed plan of restructuring.

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[7] No satisfactory explanation was forthcoming as to why this affidavit, if it needed to be filed at all, was not served and filed by December 23, 2005, in accordance with the timetable which the EH and the other stakeholders agreed to. Certainly there is nothing in the affidavit which is such late breaking news that this deadline could not have been met, let alone that it was served mere hours before the hearing commenced on January 17, 2006. Aside from the fact that the financing arrangements forming the basis of the Plan contained "no shop" covenants which would make it inappropriate and a breach to try to attract other offers, the foregoing excerpts from the Taylor affidavit clearly illustrate that despite apparently diligent efforts by the EH, no one has shown any real or realistic interest in Stelco. Reading between the lines and without undue speculation, it would appear that the efforts of the EH were merely politely rebuffed.

[8] Certainly Stelco is not Dofasco, nor is it truly a comparable (as opposed to a contrastor). Stelco has been a wobbly company for a long time. Further as I indicated in my October 3, 2005 endorsement, in the preceding 20 months under the CCAA protection, Stelco has become "shopped worn". The unusual elevation of steel prices in the past two years has helped Stelco avoid the looming liquidity crisis which it anticipated in its CCAA filing on January 29, 2004. However even this financial transfusion has not allowed it to become a healthy company or truly given it a burgeoning war chest to weather bad times the way that other steel companies (including some in Canada) have so benefited. The redness of the visage of Stelco is not a true indication of health and well being; rather it seems that it is rouge to mask a deep pallor.

[9] I am satisfied on the evidence of Hap Stephen, the Chief Restructuring Officer of Stelco and of the Monitor that there has been compliance with all statutory requirements and adherence to previous orders of the court and further that nothing has been done or purported to be done that is not authorized by the CCAA.

[10] The next question to be dealt with is whether the Plan is fair, reasonable and equitable. I was advised that creditors of the affected creditor classes representing approximately 90% in value of each class voted on the Plan. The Monitor reported at para. 19 of its 44th Report as to the results of the vote held December 9th as follows:

Class of Affected Creditors	Percentage in favour by Number	Percentage in favour by Dollar Value
Stelco	78.4%	87.7%
Stelwire	89.01%	83.47%
Stelpipe	94.38%	86.71%
CHT Steel	100%	100%
Welland Pipe	100%	100%

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[11] This favourable vote by the affected creditors is substantially in excess of the statutory two-thirds requirement. By itself that type of vote, particularly with such a large quorum present, would ordinarily be very convincing for a court not interfering with the informed decisions of business people. With that guideline, plus the aspect that a plan need not be perfect, together with the lack of any affected creditor opposition to the Plan being sanctioned and the fact that the Plan including its ingredients and nature and amount of compromise compensation to be given to affected creditors having been exhaustively negotiated in hard bargaining by the larger creditor groups who are recognized as generally being sophisticated and experienced in this area, and the consideration of the elements in the next paragraph, it would seem to me that the Plan is fair, reasonable and equitable vis-à-vis the affected creditors and I so find. See *Sammi*, at p. 173; *Re T. Eaton Co.* (1999), 15 C.B.R. (4th) 311 (Ont. S.C.J.) at p. 313; *Re Olympia & York Developments Ltd.* (1993), 12 O.R. (3d) 500 (Gen. Div) at p. 510.

[12] I also think it helpful to examine the situation pursuant to the analysis which Paperny J. did in *Re Canadian Airlines Corp.* (2000), 20 C.B.R. (4th) 1 (Alta. Q.B.), leave to appeal refused (2000), 20 C.B.R. (4th) 46 (Alta C.A. [In Chambers]). That proceeding also involved an application pursuant to the corporate legislation, the *Business Corporations Act* (*Alberta*), concerning the shares and shareholders of Canadian Airlines. In that case, Paperny J. found the following factors to be relevant:

(a) the composition of the vote: claims must have been properly classified, with no secret arrangements to give an advantage to a creditor or creditors; approval of the plan by the requisite majority of creditors is most important (in the case before me of Stelco: the challenge to classification was dismissed; there was no suggestion of secret arrangements; and, as discussed above, the quorum and size of the positive vote were very high);

(b) anticipated receipts in liquidation or bankruptcy: it is helpful if the Monitor or other disinterested person has prepared a liquidation analysis (in Stelco, the Monitor determined that on liquidation, affected creditor recovery would likely range from 13 to 28 cents on the dollar; it should also be observed that Stelco has engaged in extensive testing of the market as to possible capital raising or sale with the aid of established firms and professionals of great experience and had come up dry.);

(c) alternatives to the proposed plan: it is significant if other options have been explored and rejected as unworkable (in Stelco; see comment in (b));

(d) oppression of the rights of certain creditors (in Stelco, this was not a live issue as nothing of this sort was alleged);

(e) unfairness to shareholders (in Stelco, this will be dealt with later in my reasons; however allow me to observe that the interests of shareholders becomes engaged if they are not so far underwater that there is a reasonable prospect in the foreseeable future that the fortunes of a company would otherwise likely be turned around so that they would not continue to be submerged); and

(f) the public interest: the retention of jobs for employees and the support of the plan by the company's unions is important (in Stelco, the Plan does not call for reductions in employment; there is provision for continuation of the capital expenditure program and its funding; an important enterprise for the municipal and provincial levels of government would be preserved with continuing benefits for those communities; an important customer and supplier would continue in the industry and maintain competition; the USW International Union and its locals (except for local 1005) supported the Plan and indeed were instrumental in bringing Tricap Management Limited to the table (local 1005's position was that it did not wish to engage in the CCAA process in any meaningful way as it was content to rely upon its existing collective agreement which now still has several months to go before expiring).

However that is not the end of that issue: what of the shareholders?

[13] Is the Plan fair, reasonable and equitable for the existing shareholders of S? They will be wiped out under the Plan and their shares eliminated. New equity will be created in which the existing shareholders will not participate. They have not been allowed to vote on the Plan.

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[14] It is well established that a reorganization pursuant to s. 191 of the CBCA may be made in conjunction with a sanction order under the CCAA and that such a reorganization may result in the cancellation of existing shares of the reorganized corporation based on those shares/equity having no present value (in the sense of both value "now" and the likelihood of same having value in the reasonably foreseeable future, absent the reorganization including new debt and equity injections and permitted indulgences or other considerations and adjustments). See *Re Beatrice Foods Inc.* (1996), 43 C.B.R. (4th) 10 (Ont. Gen. Div.) at para. 10-15; *Re Laidlaw Inc.* (2003), 39 C.B.R. (4th) 230 (Ont. S.J.C.); *Algoma* at para. 7; *Cable Satisfaction International Inc. v. Richter & Associés Inc.* (2004), 48 C.B.R. (4th) 205 (Que. S.C.) at p. 217. The Dickenson Report, which articulated the basis for the reform of corporate law that resulted in the enactment of the CBCA, described the object of s. 191 as being:

> to enable the court to effect any necessary amendment to the articles of the corporation in order to achieve the objective of the reorganization without having to comply with all the formalities of the Draft Act, particularly shareholder approval of the proposed amendment (emphasis added): R.W.V. Dickenson, J.L. Howard, L. Getz, *Proposals for a New Business Corporations Law for Canada*, vol. 1 (Ottawa: Information Canada. 1971) at p. 124.

[15] The fairness, reasonableness and equitable aspects of a plan must be assessed in the context of the hierarchy of interests recognized by insolvency legislation and jurisprudence. See *Canadian Airlines* at pp. 36-7 where Paperny J. stated:

> Where a company is insolvent, only the creditors maintain a meaningful stake in its assets. Through the mechanism of liquidation or insolvency legislation, the interests of shareholders are pushed to the bottom rung of the priority ladder. The expectations of creditors and shareholders must be viewed and measured against an altered financial and legal landscape. Shareholders cannot reasonably expect to maintain a financial interest in an insolvent company where creditors' claims are not being paid in full. It is through the lens of insolvency that the court must consider whether the acts of the company are in fact oppressive, unfairly prejudicial or unfairly disregarded. CCAA proceedings have recognized that shareholders may not have "a true interest to be protected" because there is no reasonable prospect of economic value to be realized by the shareholders given the existing financial misfortunes of the company: *Royal Oak Mines Ltd.*, *supra*, para. 4., *Re Cadillac Fairview Inc.* (March 7, 1995), Doc. B28/95 (Ont. Gen. Div. [Commercial List]), and *T. Eaton Company*, *supra*.
>
> To avail itself of the protection of the CCAA, a company must be insolvent. The CCAA considers the hierarchy of interests and assesses fairness and reasonableness in that context. The court's mandate not to sanction a plan in the absence of fairness necessitates the determination as to whether the complaints of dissenting creditors and shareholders are legitimate, bearing in mind the company's financial state. The articulated

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> purpose of the Act and the jurisprudence interpreting it, "widens the lens" to balance a broader range of interests that includes creditors and shareholders and beyond to the company, the employees and the public, and tests the fairness of the plan with reference to its impact on all of the constituents.
>
> It is through the lens of insolvency legislation that the rights and interests of both shareholders and creditors must be considered. The reduction or elimination of rights of both groups is a function of the insolvency and not of oppressive conduct in the operation of the CCAA. The antithesis of oppression is fairness, the guiding test for judicial sanction. If a plan unfairly disregards or is unfairly prejudicial it will not be approved. However, the court retains the power to compromise or prejudice rights to effect a broader purpose, the restructuring of an insolvent company, provided that the plan does so in a fair manner."

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[16] The question then is does the equity presently existing in S have true value at the present time independent of the Plan and what the Plan brings to the table? If it does then the interests of the EH and the other existing shareholders must be considered appropriately in the Plan. This is fairly put in K.P. McElcheran, *Commercial Insolvency in Canada* (Toronto, Lexis Nexis Canada Inc.: 2005) at p. 290 as:

> If, at the time of the sanction hearing, the business and assets of the debtor have a value greater than the claims of the creditors, a plan of arrangement would not be fair and reasonable if it did not offer fair consideration to the shareholders.

[17] However if the shareholders truly have no economic interest to protect (keeping in mind that insolvency and the depth of that insolvency may vary according to which particular test of insolvency is applied in respect of a CCAA proceeding: as to which, see *Re Stelco Inc.*, [2004] O.J. No. 1257 (S.C.J. [Commercial List]), leave to appeal dismissed [2004] O.J. No. 1903 (C.A.), leave to appeal dismissed (S.C.C.) No. 30447). In *Cable Satisfaction*, Chaput J. at p. 218 observed that when shareholders have no economic interest to protect, then they have no claim to a right under the proposed arrangement and the "[m]ore so when, as in the present case, the shareholders are not contributing to any of the funding required by the Plan." I do note in the case of the Stelco Plan and the events leading up to it, including the capital raising and sale processes, that despite talk of an equity financing by certain shareholders, including the EH, no concrete offer ever surfaced.

[18] If the existing equity has no true value at present, then what is to be gained by putting off to tomorrow (the ever present and continuous problem in these proceedings of manãna - which never comes) what should be done today. The EH speculate, with no concrete basis for foundation as demonstrably illustrated by the eve of hearing Taylor affidavit discussed above, that something good may happen. I am of the view that that approach was accurately described in court by one counsel as a desperation Hail Mary pass and the willingness of someone, without any of his own chips, in the poker game willing to bet the farm of someone else who does have an economic interest in Stelco.

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[19] I also think it fair to observe that in the determination of whether someone has an economic value, that analysis should be conducted on a reasonable and probable basis. In a somewhat different but applicable context, I observed in *New Quebec Raglan Mines Ltd. v. Blok-Andersen*, [1993] O.J. No. 727 at p. 3:

> The "highest price" is not the price which could be derived on the basis of the most optimistic and risky assumptions without any regard as to their likelihood of being realized. It also seems to me that prudence would involve a consideration that there be certain fall back positions. Even in betting on horses, the most savvy and luckiest punter will not continue to stake all his winnings of the previous race on the next (and so on). If he does, he will go home wearing the barrel before the last race is run.

Alternatively there is a saying: "If wishes were horses, then beggars would ride."

[20] Unless I were to now dismiss the motion for sanctioning and approving the Plan because I found that it was not implementable and/or that it was not fair, reasonable and equitable to the existing shareholders (based upon the proviso that I did determine that the existing shareholders did have a valid present material equity of value), then I see no reason not to dismiss the motion of the EH concerning its request for an adjournment and its request for a further sale (or other related disposition) process. Allow me to observe that no matter how well intentioned the motion of the EH in that regard, I find that that request to be lacking in any valid substance. Rather, the evidence presented was in essence a chimera. I think it fair to observe that, with all the capital raising and sales processes to date which Stelco has undertaken in conjunction with its experienced and well placed professional advisers together with its Chief Restructuring Officer and the Monitor, the bushes have been exhaustively and well beaten as to any real possible interest. Despite three months of what one must presume to be diligent efforts, the EH have come up with nothing concrete. I do not find that the three factors mentioned by Taylor in his late-blooming affidavit of January 16th to be remotely close to convincing. The first two, if taken at face value, would lead one to the conclusion that no one has the time, interest or ability to take an interest in Stelco in any meaningful timeframe. The third presumes that the losing bidder for Dofasco, be it Arcelor or ThyssenKrupp, will almost automatically want Stelco - and at a price and upon terms which would result in present equity being attributed value. I must say in fairness that this is wishful thinking as neither of these warring bidders pursued any interest in Stelco during the previous processes. It is neither clear nor obvious why mere municipal proximity of Dofasco to Stelco's Hilton Works in Hamilton would now ignite any interest in Stelco.

[21] I also think it fair to observe that not proceeding with the sanction hearing now and indeed starting a brand new search for someone who will think Stelco so worthwhile that it will offer such a large amount (with or without onerous conditions) is akin to someone coming into court when a receiver is seeking court approval on a sale - and that someone being allowed to know the price and conditions - and then being able to make an offer for a price somewhat higher. (I reiterate that here we do not even have an offer or a price.) I do not see that such a procedure would be consistent with the principles laid out in *Royal Bank*

v. Soundair Corp. (1991), 7 C.B.R. (3d) 1 (Ont. C.A.). Given that the affected creditors have rather resoundingly voted in favour of the Plan, all in accordance with the provisions of the CCAA and the Court orders affecting the sanction, I would be of the view that if the existing equity has no value, then the EH's request in this respect would, if granted, be of significant detriment to the integrity of the insolvency system and regime. I would find that inappropriate to attempt to justify proceeding along that line.

[22] Allow me to return to the pivotal point concerning the question of whether the Plan is fair, reasonable and equitable, vis-à-vis the existing equity. The EH retained Navigant Consulting which relied upon the views of Metal Bulletin Research ("MBR") which, *inter alia*, predicted a selling spot price of hot roll steel at $525 U.S. per ton. Navigant's conclusion in its December 8, 2005 report was that the value of residual shareholder equity was between $1.1 to $1.3 billion or a per share value of between $10.76 and $12.71. However, when Stelco pointed out certain deficiencies in this analysis, Navigant took some of these into account and reduced its assessment of value to between $745 million to $945 million for residual shareholder value on per share value of $7.29 to $9.24, using a discounted cash flow ("DCF") approach. Navigant tested the DCF approach against the EBITDA approach. It is interesting to note that on the EBITDA analysis approach Navigant only comes up to a conclusion that the equity is valued at $8 million to $83 million or $0.09 to $0.81 per share. If the Court were to accept that as an accurate valuation, or something at least of positive value even if not in that neighbourhood, then I would have to take into account existing shareholder interests in determining whether the Plan was fair, reasonable and equitable – and not only vis-à-vis the affected creditors but also vis-à-vis the interests of the existing shareholders given that at least some of their equity would be above water. I understand the pain and disappointment of the existing shareholders, particularly those who have worked hard and long with perhaps their life savings tied up in S shares, but regretfully for them I am not able to come to a conclusion that the existing equity has a true positive value.

[23] The fight in the Stelco CCAA proceedings has been long and hard. No holds have been barred as major affected creditors have scrapped to maximize their recovery. There were direct protracted negotiations between a number of major affected creditors and the new equity sponsors under the Plan, all of whom had access to the confidential information of Stelco pursuant to Non Disclosure Agreements. These negotiations established a value of $5.50 per share for the new common shares of a restructured Stelco. That translates into an enterprise value (not an equity value since debt/liabilities must be taken into consideration) of $816.6 million for Stelco, or a recovery of approximately 65% for affected creditors. The parties engaged in these negotiations are sophisticated experienced enterprises. There would be no particular reason to believe that in the competition involved here that realistic values were ignored. Further, the affected creditors generally were rather resoundingly of the view by their vote that an anticipated 65% recovery was as good as they could reasonably expect.

[24] The 45th Report of the Monitor had a chart of calculations to determine the level of recovery of affected creditors at various assumed enterprise values up to and including the top end of Navigant's range of enterprise value (as contrasted with residual equity value).

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At the high end of Navigant's range of revised enterprise value, $1.6 billion, the Monitor calculated that affected creditors would still not receive full recovery of their claims.

[25] The EH cited the sale of the EDS Canada claim to Tricap as being at a premium as evidence in support of Navigant's conclusion. However, the fact was that this claim was purchased not at a premium, but rather at a discount. That would be confirmation of the opposite of which the EH has been contending.

[26] Despite a very comprehensive capital raising and asset sale process, with the market alerted and well canvassed, and with the ability to conduct due diligence, no interested party came forwarded to conclude a deal. Even since the December 9, 2005 vote when the terms of the Plan were available, no interested party has come forward with any expression of interest which would attribute value to the existing shareholders.

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[27] Stelco's experts, UBS and BMO Nesbit Burns, both have given opinions that there is no value to the existing equity. Their expert opinions were not challenged by cross-examination. Both these advisors are large sophisticated institutions; both have extensive experience in the steel industry.

[28] UBS calculated the enterprise value of Stelco as being in the range of $550 million to $750 million; BMO Nesbitt Burns at $650 million to $850 million. On that basis the unsecured creditors would receive less than full recovery of their claims, which would lead to the conclusion that there is no value for the existing shareholders. The Monitor commissioned an independent estimate of the enterprise value from its affiliate, Ernst & Young Orenda Corporate Finance Inc's Valuation Group. That opinion came in at $635 million to $785 million.

[29] I would note that Farley Cohen, the principal author of the Navigant report, does not have experience in dealing with integrated steel companies. I find it unusual that he would have customized his approach in calculating equity value by not deducting the Asset Based Lenders loan. Brad Fraser of BMO Nesbitt Burns stated that such customization was contrary to the practice at his firms both present and past and that the Navigant's approach was internally inconsistent with respect thereto as to 2005 to 2009 cash flows as contrasted with terminal value. The Navigant report appears to have forecasted a high selling price for steel combined with low costs for imports such as coal and scrap, which would be contrary to historical complementary movements between steel prices and these inputs.

[30] Navigant relies on an average price of $525 US per ton as provided by MBR. This is a single source as to this forecast. While a single analyst may come up with a forecast which is shown by the passage of time to be dead on accurate, it would seem to me to be more realistic and prudent to rely on the consensus approach of considering the views of a greater number of "representative" analysts, especially when prices appear volatile for the foreseeable future. That consensus approach allows for consideration of the way that each analyst looks at the market and the factors and weights to be given. The UBS opinion reviewed the pricing forecast of eight analysts and BMO Nesbitt Burns' ten analysts.

Interestingly, MBR's choice of a price at the top of the band would seem at odds as the statements on the MBR website foreseeing downward pressure on steel prices in 2006 because of falling prices in China; although this inconsistency was pointed out, there was no response forthcoming.

[31] Navigant estimated Stelco's financial performance for the last quarter of 2005 and made a significant upward adjustment. However, the actual experience would appear to indicate that such an adjustment would overstate Stelco's results by $124 million.

[32] Navigant's DCF approach involved a calculation of Stelco's enterprise value by adding the present value of a stream of cash flow from the present to 2009 and the present value of the terminal value determined as at 2009 so that the terminal value represents the majority (60% approximately) of enterprise value as calculated by Navigant. MBR chose a 53-year average steel price despite significant changes over that time in the industry. However, coal and scrap costs were determined as at 2009. This produced the anomalous result that steel prices are rising while costs are falling. This would imply great structural difficulties (economically and functionally) in the steel industry generally and a lack of competition. A terminal value EBITDA margin for Stelco would then be implied at approximately 26% or some 11% higher than the EBITDA margin actually achieved by Stelco in the first quarter of 2005, the most profitable quarter in the history of Stelco.

[33] Interestingly, since Navigant's approach in fact would decrease calculated value, UBS and BMO Nesbitt Burns used a weighted average cost of capital ("WACC") for Stelco in the range of 10% to 14%; Navigant used 24%. A higher WACC will result, all other things being equal, in a lower enterprise value. Navigant considered that there should be a 10% to 15% company-specific premium because of the risks associated with Stelco vis-à-vis the higher steel prices forecast by MBR. This would appear to imply that there was recognition that either MBR was aggressive in its forecasting or that price volatility would caution one to use consensus forecasting. Colin Osborne, a senior executive of Stelco, with considerable experience in the steel industry provided direct evidence on the substantial differences between each of Stelco, AK Steel, U.S. Steel and Algoma. Mr. Cohen acknowledged in cross-examination that these differences made Dofasco a more valuable company than Stelco. As set out at para. 74 of the Stelco Factum:

> 74. The specific difference identified by Mr. Osborne which made Dofasco unique include but are not limited to:
>
> (a) non-union, flexible work environment (vs. Stelco, Algoma, AK Steel and U.S. Steel);
>
> (b) legacy costs which are very low due to non-conventional profit sharing, which limits liability (vs. Stelco, AK Steel, Algoma and U.S. Steel);
>
> (c) high historical cap-ex spend per ton (vs. Stelco, Algoma and U.S. Steel);

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(d) a flexible steelmaking stream in terms of a hybrid EAF and blast furnace BOF stream in Hamilton and a mini-mill operation in the U.S. (vs. Stelco, Algoma, U.S. Steel and AK Steel which are all blast furnace based steel makers);

(e) a value added product mix focused on coated products and tubing (vs. Stelco and Algoma which focus on hot roll); and

(f) a strong raw material position with excess iron ore and self-sufficiency in coke (Algoma, Stelco and AK Steel all have dependence to various degrees on either iron ore or coke or both).

Dofasco and Stelco are not in my view fungible. There are incredible differences between these two enterprises, to the disadvantage of Stelco.

[34] The reply affidavit of Mr. Fraser of BMO Nesbitt Burns calculated the effect of all of the acknowledged corrections to the initial Navigant report and other adjustments. The result of this exercise was a conclusion by him that there was no value available for existing shareholders. This, along with all the other affidavits provided on the Stelco side, was not cross-examined on.

[35] While not referred to in the Factum of EH, there were a number of quite serious allegations raised in material filed by the EH against management of Stelco concerning bias and manipulation. Mr. Osborne responded to each of these allegations; he was not cross-examined. I find it unfortunate that such allegations appear to have been made on an unsubstantiated shotgun approach.

[36] The position of the EH is that certain of the features of the Plan should be assumed as transportable directly and without change into a scenario where some insolvency rescuer emerges on the scene as the equivalent of a White Knight, one it would seem which has been awakened from slumber. I am of the view that presumes too much. For example, I take it that the Province would not automatically accept this potential newcomer without question; nor would it likely relish the resumption of weeks of hard bargaining. I would think it unwise, impudent and high stakes poker (with other peoples' money) to speculate as did Taylor in para. 41 of his December 23, 2005 affidavit:

> 41. Were Stelco to emerge from CCAA protection and were the province to carry out its threat to revoke Stelco's entitlement to the benefit of section 5.1 the end result would likely be a liquidation of the company. The Province would be responsible for a substantial portion of Stelco's pension promise. It would clearly not be in the Province's self-interest to force Stelco into liquidation. It was, in other words, an obvious bluff. Yet the notion of calling this bluff does not appear to have crossed management's mind.

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This should be contrasted with the views of the Monitor in its 44th Report at para. 61:

> 61. It should also be noted that the Pension Plan Funding Arrangements and the $150 million New Province Note embodied in the Approved Plan were agreed to by the Province only in the context of the terms of the Approved Plan and, in particular, the capital structure, liquidity and other elements contemplated therein. The Province has advised that its proposed financing and the Pension Plan Funding Arrangements should not be assumed to be available if any of the elements of the Approved Plan are changed.

[37] The end result is that given the above analysis, I have no hesitation in concluding that it would be preferable to rely upon the analysis of UBS, BMO Nesbitt Burns and Ernst & Young Orenda, both as to their direct views as to the enterprise value of existing Stelco and as to their criticism of the Navigant and MBR reports concerning Stelco. Therefore, I conclude that the existing shareholders cannot lay claim to there being any existing equity value. Given that conclusion, it would be inappropriate to justify cutting in these existing shareholders for any piece of the emergent restructured Stelco. If that were to happen, especially given the relative values and the depth of submersion of existing equity, then it would be unfair, unreasonable and inequitable for the affected creditors.

[38] That then leaves the remaining question: Does it appear likely that the Plan will be implementable? I have been advised on Wednesday, January 18th that I would receive executed term sheets (which would address the issues raised by the Monitor discussed above) by 5 p.m., Friday, January 20th.

[39] The motion and adjournment request of the EH is dismissed.

[40] There was a request to extend the stay to March 31, 2006. I am of the view that it would be sufficient and desirable to extend the stay (subject, of course, to further extension) to March 3, 2006.

[41] I have received the term sheets together with the Monitor's 48th Report by the 5 p.m. January 20th deadline and find them satisfactory as demonstrating to my analysis and satisfaction that the Plan is implementable as discussed above, subject to a comeback provision if anyone wishes to dispute the implementability issue (the onus remaining on Stelco). My decision today re: implementability should in no way be taken as deciding any corporate reorganization issue or anything of that or related nature. I therefore sanction and approve the Plan.

J.M. Farley

DATE: January 20, 2006

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Tab 3

Re

Central Capital Corporation
Re Royal Bank of Canada et al. and Central Capital Corporation
[Indexed as: Central Capital Corp. (Re)]

27 O.R. (3d) 494

[1996] O.J. No. 359

Nos. C21479 and C21477

Court of Appeal for Ontario,

Finlayson, Weiler and Laskin JJ.A.

February 7, 1996

Bankruptcy -- Insolvency -- Companies' Creditors Arrangement Act -- Vendor receiving preference shares with right of retraction -- Purchaser company unable to redeem shares because of insolvency -- Purchaser reorganizing under plan of arrangement -- Right to participate in reorganization as creditor depending upon whether person having claim provable in bankruptcy -- Vendor claiming that exercise of right of retraction a debt and a claim provable in bankruptcy -- Court characterizing transaction as equity -- Canada Business Corporations Act, R.S.C. 1985, c. C-44 -- Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36 -- Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3.

Debtor and creditor -- Companies' Creditors Arrangement Act -- Vendor receiving preference shares with right of retraction -- Purchaser company being unable to redeem shares because of insolvency -- Purchaser company reorganizing under plan of arrangement -- Right to participate in reorganization as creditor depending upon whether person having claim provable in bankruptcy -- Vendor claiming that exercise of right of retraction a debt and a claim provable in bankruptcy -- Court characterizing transaction as equity -- Canada Business Corporations Act, R.S.C. 1985, c. C-44 -- Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36 -- Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3.

In 1987, through a corporation, M sold shares to Central Capital Corp. and received in return Series B Senior Preferred Shares. These shares, which were to be listed on the stock exchange, contained a provision entitling the holder to retract the share at a specified price, i.e., to have them redeemed by Central Capital Corp. on July 1, 1992 for $25 per share plus all accrued and unpaid dividends but providing that redemption would not be contrary to law. In 1989, the predecessor of SYH Corp. sold the shares of several insurance companies to Central Capital Corp. and in return received Series A and Series B Junior Preferred Shares. These shares contained a provision entitling the holder at its option to retract the shares on or after September 1994 for $1.00 per share plus all accrued and unpaid dividends, but subject to the provisions of the Canada Business Corporations Act (CBCA).

In December 1991, Central Capital, which was then insolvent, defaulted on its financial obligations, and, in 1992, creditors commenced proceedings under the Companies' Creditors Arrangement Act (CCAA). An administrator was appointed and assets were transferred to implement a two-pronged reorganization and plan of compromise in which certain creditors of Central Capital would exchange a portion of their indebtedness for shares and debentures of a new corporation and creditors of Central Capital would receive 90 per cent of the common shares in a reorganized Central Capital. The balance of common shares was to be allocated to the shareholders. To participate in the reorganization as a creditor, s. 12(1) of the CCAA required that a person have a claim provable

in bankruptcy. Section 121(1) of the Bankruptcy and Insolvency Act (BIA) provided that all debts, present and future, shall be deemed to be provable claims.

In April and May 1992, M exercised his right of retraction, but Central Capital did not redeem the shares, and M subsequently submitted a proof of claim. In September 1992, SYH Corp. delivered a proof of claim. The administrator disallowed these claims because it would be contrary to the CBCA for Central Capital to redeem the shares due to its financial position and, in the case of SYH Corp., also because the date for redemption had not yet occurred. This decision was upheld on appeal, Feldman J. ruling that M and SYH Corp. were not creditors because they did not have a claim provable under the BIA. M and SYH Corp. appealed to the Court of Appeal.

Held, the appeal should be dismissed.

Per Weiler J.A.: To decide whether the obligation to redeem the preferred shares was a claim in bankruptcy, it was necessary to characterize the transaction. The court must look to the surrounding circumstances to determine whether the relationship here was that of a shareholder with equity or that of a creditor owed a debt. The sales of shares by M and by SYH Corp. were changes in a capital investment from a smaller to a larger entity. There were the hallmarks of a shareholding, i.e., there was: risk-taking; profit-sharing; transferability of investment by sale on the stock exchange or, in the case of SYH Corp., by private sale; and the right to participate in the share of assets on a liquidation after the creditors had been paid. The true nature of the transaction was that of an equity transaction. The equity nature of the transaction did not change into a debt by M attempting to exercise the right of retraction nor did it change as a result of the reorganization of Central Capital. The preferred shares were part of the capital of Central Capital, and s. 36 of the CBCA makes the ability of a corporation to redeem its shares subject to its articles and to a solvency requirement. In this case, by the terms of the preferred shares, an unsatisfied demand for retraction did not make any change in the holder's status as a shareholder entitled to receive dividends, to vote at meetings in certain circumstances, and to participate in a liquidation. Because Central Capital could not comply with the solvency requirements, redemption would be contrary to law. Further, the accrued but undeclared dividends on the preference shares were not made a debt by reason of their being part of the retraction price. Dividends may only be declared if a company is solvent. Any obligation to pay a dividend cannot be enforced when the company is insolvent. Accrued but unpaid dividends are akin to a return of capital and this was not altered by making these accrued dividends part of the retraction price. Finally, the nature of the preference shares did not provide the appellants with a claim provable in bankruptcy. Persuasive authority exists that a claim provable in bankruptcy must be one recoverable by legal process. In this case, although there was a right to receive payment, the effect of the insolvency meant that there was no right to enforce payment and no claim provable within the meaning of s. 121 of the BIA.

Per Laskin J.A. (concurring): Although the relations between each appellant and Central Capital had the characteristics of debt and equity, in substance they were shareholders and the exercise of their retraction rights did not convert them into creditors. In determining the substance of the relationship, the court looks to what the parties intended. In these appeals, what the parties intended was indicated in the share purchase agreements, the conditions attaching to the preference shares, in the articles of incorporation, and in the way Central Capital recorded the appellants' shares in its financial statements. These factors indicated that appellants were making an investment in capital and not extending credit; they chose equity, not debt. The appellants' status was not changed by the exercise of the rights of retraction. The share conditions provided that even after exercising their rights, the appellants continued to enjoy rights of shareholders. The right of retraction provided for the return of capital, not the repayment of a loan, and a preferred shareholder exercising this right on the terms that existed here ranked behind a company's creditors on a liquidation. The result should be the same on a reorganization. Moreover, holding that the appellants were creditors would defeat the purpose of s. 36(2) of the CBCA, which prohibited the redemption of the shares when there was insolvency. The purpose of this provision was to protect creditors and prevent shareholders from recouping their investments to the detriment of creditors. Creditors rely on these protections in making loans to companies. Permitting preferred shareholders to be turned into creditors by endowing their shares with retraction rights was contrary to the policy of creditor protection.

Per Finlayson J.A. (dissenting): The question to be decided was whether the appellants' shares created a debt, present or future, within the meaning of s. 121 of the BIA. The character of an instrument is revealed by its language and the circumstances of its creation. Although these instruments were shares until there was redemption, they also contained a specific promise to pay at a specified date. This was the language of debt. The circumstances of the issue of these shares showed that they were not issued to raise capital but rather were a means of payment for the acquisition of specified assets. Central Capital was using the retraction provisions as a vehicle for financing its expanding asset base. The fact that the appellants, as holders of the shares, had rights of shareholders in the corporation up to the time when the retraction clauses were exercisable did not affect their

right to enforce payment of the retraction price when it became due. The insolvency of Central Capital and any impropriety of redeeming the shares because of Central Capital's financial position did not change their nature as debts and did not change the nature of the relationship of debtor and creditor. Further, the arguments against the appellants' claims ignored that debts under s. 121(1) of the BIA need only come beneath the broad umbrella of "debts and liabilities, present and future". The fact that the debts could not be paid after June 1992 did not mean that they were not provable claims.

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Statutes referred to

Assignments and Preferences Act, R.S.O. 1990, c. A.33
Bankruptcy Act, R.S.C. 1970, c. B-3, s. 95(1) -- now R.S.C. 1985, c. B-3, s. 121(1)
Bankruptcy and Insolvency Act (as renamed by S.C. 1992, c. 27, s. 2), R.S.C. 1985, c. B-3, ss. 2 "claim provable", "creditor", 95, 96, 101, 121(1)
Canada Business Corporations Act, R.S.C. 1985, c. C-44, ss. 2 "liability", 12(1), 20, 25(3), 34, 35, 36, 39, 40, 42, 173, 191
Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, s. 12(1)
Cooperative Association Act, R.S.B.C. 1979, c. 66
Fraudulent Conveyances Act, R.S.O. 1990, c. F.29
Law of Property Act, R.S.A. 1980, c. L-8
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APPEAL from an order of Feldman J. (1995), 29 C.B.R. (3d) 33, 22 B.L.R. (2d) 210 (Gen. Div.), in proceedings under the Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36.

Bryan Finlay, Q.C., and John M. Buhlman, for appellants, James W. McCutcheon and Central Guaranty Trust.
James H. Grout and Anne Sonnen, for appellant, Consolidated S.Y.H. Corp.
Terrence J. O'Sullivan and Paul G. Macdonald, for the unsecured creditors of Central Capital Corp.
Neil C. Saxe, for Peat Marwick Thorne Inc.

FINLAYSON J.A. (dissenting): -- The appellant James W. McCutcheon and Central Guarantee Trust Company as Trustee for the Registered Retirement Savings Plan of James W. McCutcheon (hereinafter sometimes referred to collectively as "McCutcheon") and the appellant Consolidated S.Y.H. Corporation ("SYH") appeal from the order of the Honourable Madam Justice Feldman of the Ontario Court (General Division) dated January 9, 1995 (reported as Re Central Capital Corp. (1995), 29 C.B.R. (3d) 33, 22 B.L.R. (2d) 210). Feldman J. dismissed appeals from decisions dated January 20, 1993 and February 16, 1993 of the respondent Peat Marwick Thorne Inc., in its capacity as Interim Receiver, Manager and Administrator ("Administrator") of certain assets of Central Capital Corporation ("Central Capital"). The Administrator disallowed proofs of claim submitted by the appellants with respect to a plan of arrangement under the Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36 ("CCAA"). Leave to appeal the order of Feldman J. was granted on March 17, 1995 by the Honourable Mr. Justice Houlden.

Overview of the Proceedings

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

(a) it was unable to pay its liabilities as they became due; and
(b) the realizable value of its assets was less than the aggregate of its liabilities.

By notice of application issued June 12, 1992, 39 of the creditors commenced an application pursuant to the CCAA for an order declaring the following: that Central Capital was a debtor company to which the CCAA applied; that Peat Marwick Thorne Inc. be appointed Administrator of the property, assets and undertaking of Central Capital; that a stay of proceedings against Central Capital, except with leave of the court, be granted; and that the applicants be authorized and permitted to file a plan of compromise or arrangement under the CCAA.

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

(a) Peat Marwick Thorne Inc. was appointed Administrator, Interim Receiver and Manager of such of the undertaking, property and assets of Central Capital as necessary for the purpose of effecting the transaction described in the order pursuant to which specified significant assets of Central Capital would be transferred to a newly incorporated company called Canadian Insurance Group Limited ("CIGL");
(b) the Administrator was authorized to enter into and carry out a subscription and escrow agreement with creditors of Central Capital pursuant to which creditors of Central Capital would be entitled to elect to exchange a portion of the indebtedness owing to them by Central Capital for shares and debentures to be issued by CIGL;
(c) the Administrator was authorized and directed to supervise the calling for claims of creditors of Central Capital who elected to exchange a portion of the indebtedness from Central Capital for shares and debentures to be issued by CIGL as aforesaid; and
(d) Central Capital was authorized and permitted to file with the court a formal plan of compromise or arrangement with Central Capital's secured and unsecured creditors and

shareholders in accordance with the CCAA and the Canada Business Corporations Act, R.S.C. 1985, c. C-44 (the "CBCA"), which would provide for the restructuring and reorganization of the debt and equity of Central Capital in the manner set out in the said order.

According to the agreed statement of facts, the order of Houlden J. was made without prejudice to the rights of the appellants to assert claims as creditors in the CIGL transaction. Pursuant to the terms of the July 9, 1992 order, all claims of creditors of Central Capital who wished to participate in CIGL were required to be submitted to the Administrator by September 8, 1992, or such other date fixed by the court. The Administrator received claims from various persons who wished to participate, including the claims submitted by the appellants herein.

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

Issue

The agreed statements of facts sets out the issue in the appeal in the following language:

> Do the appellants, or any of them, have claims provable against CCC [Central Capital] within the meaning of the Bankruptcy Act (Canada), as amended as of the date of the Restated Subscription and Escrow Agreement? If the appellants, or any of them, have provable claims, then the proof of claim of any appellant that has a claim provable is to be allowed as filed and the appeal from the disallowance allowed, and the appellants, or any of them, whose claim is allowed are to participate in the Plan of Arrangement of Central Capital as a senior creditor.

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

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

Overview of the Restructuring of Central Capital

The order of Houlden J. of July 9, 1992 directed the restructuring of Central Capital under the aegis of the court. The order, and others that would follow, contemplated that the restructuring would take place in two stages. The first stage involved the transfer to the Administrator of certain major assets of Central Capital to a company to be incorporated called Central Insurance Group Limited (CIGL). This company is frequently referred to in the documentation and the reasons of Feldman J. as "Newco". CIGL was then to be owned by those Central Capital creditors who chose to participate in the reorganization by accepting a reduction in their debts due from Central Capital and exchanging this reduced indebtedness for debentures in CIGL. Subscription for debentures by this means additionally entitled the creditors to subscribe for shares in CIGL. Our understanding from counsel is that the assets transferred to CIGL included the assets acquired by Central Capital from the appellants in purchase agreements described later in these reasons.

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

The second stage of the restructuring involved a plan of arrangement under the CCAA. That plan as put forward by Central Capital recognized four classes of creditors, only one of which, namely that of "Senior Creditors", could apply to the appellants. The plan of arrangement, as amended, provided that Central Capital would issue to Senior Creditors pro rata on the basis of their senior claims a class of secured promissory notes in the aggregate principal amount of $20 million of secured debt, which were to be known as first secured notes. A similar arrangement was made for the issuance of $1 million of second secured promissory notes to subordinated creditors. Senior and subordinated creditors included any creditor whose claim had been allowed under the CIGL claims procedure in the first stage, to the extent of that creditor's reduced claim.

The plan of arrangement also called for the creation of a new class of shares in Central Capital to be called the Central New Common Shares. Central Capital would issue to the above Senior and Subordinated Creditors 90 per cent of the new share capital of Central Capital in extinguishment of the balance of their debt. The Central Capital shareholders of all classes would have their existing shares converted into the remaining 10 per cent of the Central New Common Shares. All of the existing preferred and common shares would be cancelled upon implementation of the plan.

The amended plan of arrangement was ultimately voted on and approved by all four classes of creditors of Central Capital. On December 18, 1992, Houlden J. sanctioned this plan of arrangement under the CCAA. He authorized and directed Central Capital to apply for articles of reorganization pursuant to s. 191 of the CBCA, so as to authorize the creation of the Central New Common Shares for implementation of the amended plan of arrangement. He also lifted the stays of proceedings affecting Central Capital and its ability to carry on business as of January 1, 1993.

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

Facts as they Relate to the Claim of McCutcheon

By a share purchase agreement dated June 15, 1987 between Central Capital and Gormley Investments Limited ("Gormley") and Heathley Investments Limited ("Heathley"), Central Capital agreed to purchase all Class "B" voting shares of Canadian General Securities Limited ("CGS") that were owned by Gormley and Heathley. James W. McCutcheon and his brother, who were the sole shareholders of Gormley, represented to Central Capital that CGS owned substantially all of the shares of Canadian Insurance Sales Limited, which in turn owned substantially all of the shares in a number of operating insurance, credit and trust companies. The consideration for the purchase of the CGS shares was $575 per share. The vendors were to be paid $400 per share in cash on closing and were to receive seven Series B senior preferred shares of Central Capital. These shares contained a retraction clause entitling the holder to retract each preferred share on July 1, 1992 for $25. Failing issuance of the shares by Central Capital, the vendors were to receive an additional $175 for each CGS share. The share purchase agreement and later the Articles of Central Capital further provided that the holders of Series B Senior Preferred Shares were entitled to receive dividends as and when declared by the directors of Central Capital out of moneys of the corporation properly applicable to the payment of dividends and in the amount of $1.90625 per share per annum (being 7 5/8 per cent per annum on the stated capital of $25 per share) payable in equal quarterly payments. No dividends were in fact declared.

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

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

Article 4.2 of the Senior Series B Provisions sets out the procedure for retraction of the shares. Article 4.3 of the Senior Series B Provisions provides that if the redemption by Central Capital of all of the Series B Senior Preferred Shares required to be redeemed on the retraction date would be contrary to applicable law or the rights,

privileges, restrictions and conditions attaching to any shares of Central Capital ranking prior to Series B Senior Preferred Shares, then Central Capital shall redeem only the maximum number of Series B Senior Preferred Shares which it determined was permissible to redeem at that time. Article 4.3 provides the mechanism for a pro rata redemption from each holder of the tendered Series B Senior Preferred Shares and redemption of the tendered Series B Senior Preferred Shares by Central Capital at further dates.

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

Article 4.4(b) of the Senior Series B Provisions provides that if the retraction price is not paid by Central Capital, Central Capital shall forthwith notify each holder of the Series B Senior Preferred Shares who has not received payment for his deposited shares of the holder's right to require Central Capital to return all (but not less than all) of the holder's deposited share certificates and the holder's rights under art. 4.3 outlined above.

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

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

A notice of retraction privilege was sent by Central Capital to the holders of Series B Senior Preferred Shares with a cover letter dated April 23, 1992. The letter stated, among other things, that Central Capital would not redeem any shares because the redemption of such shares would be contrary to applicable law in the context of Central Capital's then current financial situation. McCutcheon and Central Guaranty Trust deposited for redemption 406,800 and 26,000 Series B Senior Preferred Shares, respectively, in accordance with the Senior Series B Provisions and the notice of retraction privilege. The shares were deposited on May 28, 1992, with Montreal Trust Company of Canada, pursuant to the notice of retraction privilege. The shares were properly tendered for redemption in the manner and within the time required by Central Capital's articles of amendment.

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

Pursuant to the terms of Houlden J.'s order of July 9, 1992 directing the restructuring of Central Capital, McCutcheon submitted to the Administrator, as a creditor of Central Capital, proofs of claim dated September 3, 1992 and September 4, 1992, respectively. McCutcheon claimed the amount of $10,913,593.69 in respect of his Series B Senior Preferred Shares tendered for redemption. Central Guaranty Trust claimed the amount of $697,526.68 in respect of its tendered 26,000 Series B Senior Preferred Shares. McCutcheon also executed and submitted the restated subscription and escrow agreement and other documents electing to participate in CIGL. These claims were completed and submitted in the prescribed form and within the time required by Houlden J.'s order.

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

> 36(1) [Redemption of shares] Notwithstanding subsection 34(2) or 35(3), but subject to subsection (2) and to its articles, a corporation may purchase or redeem any redeemable shares issued by it at prices not exceeding the redemption price thereof stated in the articles or calculated according to a formula stated in the articles.

(2) [Limitation] A corporation shall not make any payment to purchase or redeem any redeemable shares issued by it if there are reasonable grounds for believing that

(a) the corporation is, or would after the payment be, unable to pay its liabilities as they become due; or
(b) the realizable value of the corporation's assets would after the payment be less than the aggregate of

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

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

Facts as they Relate to the Claim of SYH

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

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

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

Given that the operative date for proving claims against Central Capital was June 15, 1992, the retraction date governing the preferred shares of SYH was some two years removed. Notwithstanding, on September 8, 1992 SYH executed and delivered to the Administrator a proof of claim, a counterpart of the restated subscription and escrow agreement, an initial share subscription and an instrument of claims reduction form, all in the prescribed form and within the time required. The claim was that SYH was holding or entitled to hold the following shares of Central Capital:

(a) 60,116,000 Junior Preferred Series A shares;
(b) 9,618,560 Junior Preferred Series B shares;
(c) 4,611,095 Junior Preferred Series B shares accrued to June 15, 1992 but not yet issued to SYH;

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

By notice of disallowance dated January 20, 1993, the Administrator disallowed the claim by SYH to subscribe for debentures and common shares to be issued by CIGL. The reasons for the disallowance are similar to those

provided for disallowing the claims of McCutcheon. The Administrator found that SYH's right to require Central Capital to retract the Series A and B Junior Preferred Shares only arose on the expiry of the fifth anniversary of their issuance and that Central Capital was precluded from retracting those shares by virtue of its insolvency and the provisions of the CBCA. Hence SYH, like McCutcheon, was limited to exercising what other rights it might have as a shareholder.

Analysis

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

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

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

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

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

> Debt. A sum of money due by certain and express agreement. A specified sum of money owing to one person from another, including not only the obligation of debtor to pay but right of creditor to receive and enforce payment . . .
>
> A fixed and certain obligation to pay money or some other valuable thing or things, either in the present or in the future.

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

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

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

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

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

With great respect to the judge of first instance and to the submissions of counsel for the unsecured creditors,

I believe that the fundamental error that has been made in these proceedings arises from the conception that the preferred shares in question can either be debt instruments or equity participation instruments, but they cannot have the attributes of both. Feldman J. had this to say at p. 48 of her judgment:

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

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

The rules relating to the competing rights of shareholders and creditors of an insolvent corporation have become so regulated by governmental action that one can readily lose sight of the common law basis for making a distinction. To understand the difference in treatment, we must re-examine what a share of a corporation represents. Initially, a share is issued by the corporation to raise share capital. The price of the share is money or the promise of money. Accordingly, an individual share is one of a number of separate but integral parts of the authorized capital of a corporation. Even though it is the shareholders who contribute to the capital of the corporation, the capital remains the property of the corporation. The shareholders, however, as owners of the shares of capital, effectively control the corporation. They have the responsibility of managing its affairs through their control over the board of directors and in popular terminology are considered to be the owners of the corporation. However, the corporation is a separate entity in law, and if in the course of carrying out its business it incurs debts to third parties, those debts are those of the corporation. A corporation is an intangible and its capital therefore represents its substance to third parties having business dealings with the corporation. A preferred share is simply a share of a class of issued shares which contains a preference over other classes of shares, whether preferred or common: see Sutherland, Fraser and Stewart on Company Law of Canada, 6th ed. (1993), at pp. 157 and 195 for further discussion.

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

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

Shareholders are variously characterized as entrepreneurs, investors or risk-takers and as such they have the opportunities of benefitting from the successes of the corporation and suffering from its failures. While the corporation is an operating entity, the shareholders receive their rewards, if there are any, through the payment of dividends declared from time to time by the board of directors. While the source of these dividends is not restricted to surplus funds, the result of the payment of the dividend must not result in a return of capital to the shareholders. The classic justification for this rule was stated by Sir George Jessel, Master of the Rolls, in Flitcroft's Case (1882), 21 Ch. D. 519 at pp. 533-34, 52 L.J. Ch. 217 (C.A.):

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

Creditors, on the other hand, do not have an ownership or equity interest in the corporation. They are third parties who have loaned money or otherwise advanced credit to the corporation. They look to the company for payment in accordance with the terms of the contract creating the indebtedness. They are also restricted in their recovery to the amounts stipulated in the terms of indebtedness. They are entitled to payment regardless of the financial circumstances of the debtor corporation and accordingly are not restricted to receiving payment of the debt from surplus. They can be paid out of assets or through the creation of further indebtedness. It is immaterial how the corporation records this indebtedness in its internal books. In some circumstances the indebtedness could properly reflect the acquisition of property from a creditor as a capital asset. This does not, however, convert the creditor into an investor. The vendor of the property remains a creditor and retains priority over shareholders in the event of a bankruptcy or insolvency.

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

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

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

The validity of an analysis directed to the substance of the transaction is supported by Canada Deposit Insurance Corp. v. Canadian Commercial Bank, [1992] 3 S.C.R. 558, 97 D.L.R. (4th) 385, a judgment of the Supreme Court of Canada delivered by Iacobucci J. The case involved a number of corporations constituting a support group which entered into an arrangement to provide emergency financial assistance to Canadian Commercial Bank ("CCB"). On the ultimate failure of the bank, the issue arose as to whether the moneys advanced to CCB under this support arrangement were in the nature of a loan or in the nature of a capital investment. I find instructive to our situation Iacobucci J.'s observation at pp. 590-91:

> As I see it, the fact that the transaction contains both debt and equity features does not, in itself,

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

(Emphasis in original)

I have no difficulty in finding that the appellants' preferred shares with their retraction clauses are of "a hybrid nature, combining elements of both debt and equity". As to the equity component, the appellants are shareholders prior to exercising their retraction rights in that they have the right to vote in certain circumstances and have a right to receive dividends when and if they are declared by the board of directors. The debt component is more significant however. The shares were not issued to investors, but to vendors of property. The vendors were entitled to receive a fixed sum at a specified time in payment therefor. Pending payment, the vendors were entitled to receive dividends which were the equivalent of interest on the unpaid balance.

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

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

The narrow issue of the effect of insolvency on a debt has been dealt with by the British Columbia Court of Appeal in Re East Chilliwack Agricultural Co-Operative (1989), 74 C.B.R. (N.S.) 1, 58 D.L.R. (4th) 11. In this case, the appellants were one-time members of three co-operative associations. The rules of the co-operatives permitted a member to withdraw upon written notice to the board of directors to that effect. The member was entitled to elect to have his shares redeemed either in equal instalments over five years or in one payment with interest at the end of five years. In April of 1987, the superintendent of co-operatives, under the authority of the Cooperative Association Act, R.S.B.C. 1979, c. 66, suspended the co-operatives' right to redeem their shares until their financial situation was no longer impaired. The three co-operatives subsequently went bankrupt and a two-fold issue came before the bankruptcy court: (1) whether those members whose notices of withdrawal had been accepted by the board of directors but who had not yet received the value of the shares were entitled to rank as unsecured creditors, and (2) whether those who had delivered notices that had not been accepted were to be treated as unsecured creditors. The court of first instance found that the members were shareholders and answered both questions in the negative. That judge was reversed on appeal with the majority of the court deciding that the answer to both questions was yes. Hutcheon J.A. for the majority stated at p. 13:

> I shall use Mr. Neels [a co-operative member] as my example. According to R. 3.06 he ceased to be a shareholder in May 1983. In May 1984 the Agricultural Co-operative owed him the first of five payments, or $686.40. I know of no principle of law that would support the proposition that Neels could not sue for that amount if the Agricultural Co-operative failed to pay in May 1984. Of course, the superintendent of co-operatives has power under s. 15(2) to suspend payments if, in his opinion, the financial position of the co-operative was impaired. Subject to that power, the position of Neels and the Agricultural Co-operative would be that of ordinary creditor and debtor. In my opinion, the

order made by the judge cannot be sustained on the first ground.

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

It appears to me, with deference, that the issue of the effect of Central Capital's insolvency on the character of the retraction payments is something of a red herring. The contest in this appeal is between those who are conceded to be unsecured creditors and those whose claim to such status is contested. In both cases, any right to payment was suspended by Central Capital's announcement in December of 1991 that it was insolvent and that it had suspended all payments of principal and interest to unsecured creditors. This course of action was not freely chosen but was required by law. Any payments to creditors after the date of insolvency would be voidable at the instance of creditors on the basis that they were fraudulent preferences. In addition to ss. 95 and 96 of the Bankruptcy Act dealing with fraudulent preferences generally, there is provincial legislation in the form of the Fraudulent Conveyances Act, R.S.O. 1990, c. F.29, and the Assignments and Preferences Act, R.S.O. 1990, c. A.33, that would be applicable. Counsel for the unsecured creditors maintains that the right to redeem shares, including preference shares, was postponed by s. 36(2) of the CBCA, supra. I am not certain that s. 36(2) applies to the retraction provisions of the appellants' preference shares as opposed to the redemption privileges of Central Capital, but in my opinion the point is irrelevant to this appeal. Once Central Capital acknowledged its insolvency, it could neither redeem its shares nor honour its retraction obligations. The whole purpose for the creditors applying to the court for a stay of Central Capital's obligations, including those of the acknowledged unsecured creditors, was to arrange for a scheme of payments to all creditors that could not be subject to attack as preferences. There is no suggestion on the evidence before us that the claims of unsecured creditors accepted by the Administrator were claims that had crystallized prior to the insolvency of Central Capital. Nor is it suggested that any creditors were rejected because some or all of their claims were not payable until after the date of the insolvency. The fact of insolvency, by itself, does not provide a rational basis for distinguishing the claims of the appellants from those of other unsecured creditors.

Much also was made of the provision in the Articles authorizing the shares in question, which states that if the obligation to redeem "would be contrary to applicable law", then Central Capital "shall redeem only the maximum number of [shares] it is then permitted to redeem". Counsel for the unsecured creditors submits that the reference to "applicable law" is to s. 36 of the CBCA. The reference certainly embraces the CBCA, but it is not restricted by its terms to that statute. For example, "applicable law" would also capture s. 101 of the Bankruptcy and Insolvency Act, which provides for penalties against directors and shareholders where insolvent companies redeem shares or pay dividends.

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

In summary then regarding the insolvency argument, these various statutes prohibit payments of any kind to shareholders by an insolvent company. As I understand it, counsel does not question that when a dividend has been lawfully declared by a corporation, it is a debt of the corporation and each shareholder is entitled to sue the corporation for his proportion: see Fraser and Stewart, supra, at p. 220 for a list of authorities. However, once a company is insolvent it cannot make payments to shareholders or creditors so long as it continues to be insolvent. On the other hand, nowhere in the CBCA or elsewhere will we find authority for the proposition that once a corporation is insolvent, it is no longer obliged to pay its debts. The obligation is postponed until the insolvency is corrected or the corporation makes an accommodation with its creditors and obtains a release with or without the assistance of the various statutes dealing with insolvency.

The existence of provisions prohibiting payment to shareholders and creditors on insolvency does not in any way assist the determination of whether the retraction obligations at issue in this appeal constitute a debt or a return of capital at the time they are payable. Speaking of the obligation to honour the retraction in terms of the corporation redeeming its shares also introduces the wrong emphasis. The corporation is not redeeming the shares at its option as contemplated by most redemptions. It is being forced to redeem them because of a prior

contractual obligation for which the preferred shareholder gave good consideration. It is for this reason that I question whether s. 36 of the CBCA is the appropriate reference point. This is not the type of payment which concerned Jessel M.R. in Flitcroft's Case, supra.

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

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

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

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

I have two responses to this submission. The first is the obvious, that we are not dealing with this contemplated event. We are dealing with a reorganization in which the parties have put a single question to the court: are the appellants creditors? Consideration of issues of priority or the valuation of claims have been taken away by the narrow scope of the agreed question. If the answer to the question posed is yes, then in accordance with the agreed statement of facts, the appellants are entitled to have their claims as creditors allowed under the subscription and escrow agreement and to participate in the amended plan of arrangement as senior creditors. If the answer is no, they are to be treated as the Administrator has treated them: they are not creditors at all and are restricted to receiving Central New Common Shares under the amended plan of arrangement.

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

Finally, with respect to SYH's claims, it was submitted that these claims were so contingent as to be virtually

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

Based on the reasons set out above, I have concluded that the retraction amounts do fall within the definition of debts and liabilities, present or future, to which Central Capital was subject on June 15, 1992. This does not apply to undeclared dividends, however, because until a dividend is declared no action on behalf of a shareholder lies to enforce its payment: see Fairhall v. Butler, [1928] S.C.R. 369 at p. 374, [1928] 3 D.L.R. 161. If undeclared dividends have been claimed by any of the appellants they should be disallowed. In all other respects the claims should be allowed.

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

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

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

In order to decide whether the obligation of Central Capital to redeem the preferred shares of the appellants is a claim provable in bankruptcy, it is necessary to characterize the true nature of the transaction. The court must look to the surrounding circumstances to determine whether the true nature of the relationship is that of a shareholder who has equity in the company or whether it is that of a creditor owed a debt or liability by the company: Canada Deposit Insurance Corp. v. Canadian Commercial Bank, [1992] 3 S.C.R. 558, 97 D.L.R. (4th) 385. In this case, the decision is not an easy one. Where, as here, the agreements between the parties are reflected in the articles of the corporation, it is necessary to examine them carefully to characterize the true relationship. It is not disputed that if the true nature of the relationship is that of a shareholder-equity relationship after the retraction date and at the time of the reorganization, then the appellants do not have a claim provable in bankruptcy. Consequently, they will not have a claim under the CCAA.

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

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

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

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

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

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

James McCutcheon and his brother sold their shares in Central Guarantee Trust Company to Central Capital Corporation ("Central Capital"), a trust company, for $575 a share. They received $400 per share in cash. The balance of $175 owing on each share was paid through the issue of seven preferred shares in Central Capital, with each share having a par value of $25. Following this transaction, McCutcheon purchased his brother's shares. These preferred shares, known as Senior Series B Preferred Shares, were to be listed on the Toronto Stock Exchange. These shares carried with them a retraction privilege. The shareholder had the right to have his shares redeemed by Central Capital on July 1, 1992, for $25 a share, provided that such redemption would not be "contrary to law in the context of the Corporation's current financial position". McCutcheon chose not to sell his shares.

Scottish & York Holdings Limited (the predecessor to SYH) sold its shares in certain insurance companies which it owned to Central Capital. Central Capital paid for these shares by the issue of Series A Junior Preferred Shares. These shares were not posted on a stock exchange. SYH had the right to have its shares redeemed by Central Capital on or after September 1994 at a price of $1.00 per share, subject to the provisions of the Canada Business Corporations Act, R.S.C. 1985, c. C-44 (the "CBCA").

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

By December 1991, Central Capital was unable to pay its liabilities as they became due and its total liabilities greatly exceeded the value of its assets. As a result, the various banks and subordinated debtholders, collectively referred to as the lenders, had a choice to make. Inasmuch as the definition of a corporation in s. 2 of the Bankruptcy and Insolvency Act precludes a creditor from bringing a petition against a trust company, they could either wind up Central Capital under the Winding-up Act, R.S.C. 1985, c. W-11, or they could try to restructure Central Capital under the CCAA. In a winding-up or liquidation, the trustee would sell the company's assets, either piecemeal or as a going concern, to third parties. The proceeds from the sale would then be distributed to those who proved a claim according to set priority rules. In a reorganization, existing fixed amounts owed to Central Capital's creditors would be traded for new claims and ownership interests in the reorganized corporation which would remain a going concern. The lenders chose to reorganize.

Two transactions were involved. In the Consolidated Insurance Group Limited transaction, or "CIGL transaction", Central Capital transferred some of its significant assets to a newly incorporated company, CIGL. Thirty-nine creditors of Central Capital then elected to exchange a portion of Central Capital's debt owing to them for equity in this newly incorporated company. In the second transaction, common shares were issued for the remaining assets of Central Capital. The creditors of Central Capital were given 90 per cent of the common shares of the reorganized company. The balance of 10 per cent was allocated to the shareholders of Central Capital. All of the preferred, common and subordinate voting shares in Central Capital were then converted into these "new" common shares. The reorganization was subsequently approved by the creditors and sanctioned by the court as required by the Act, but this approval was given without prejudice to any claims that McCutcheon and SYH might have.

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

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

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

Finlayson J.A. is of the opinion that the nature of this transaction is different and that Feldman J. erred in not showing sensitivity to the fact that she was dealing with the sale of a business by its owners. He is of the opinion that the shares issued by Central Capital are the equivalent to "vendor shares" in that the appellants received them in exchange for the transfer of assets to Central Capital. He does not see the transaction as being either a

contribution to capital by McCutcheon and SYH or as a return of capital. Although the transaction has debt and equity features, Finlayson J.A. is of the opinion that the true nature of the transaction is that of a debt owing by Central Capital to McCutcheon and SYH for the shares in their companies.

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

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

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

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

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

(a) Nature of the transaction's relationship to the capital structure of the corporation

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

(b) Section 36 of the CBCA

Section 36 of the CBCA makes the ability of a corporation to redeem its redeemable shares subject to (1) its

articles and (2) a solvency requirement. For ease of reference s. 36 is reproduced below.

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

(Emphasis added)

There is no dispute that Central Capital was unable to redeem McCutcheon's shares on the retraction date. Nor could it redeem SYH's shares on the date of the reorganization. The appellants agree that the effect of s. 36 renders the agreement between themselves and Central Capital unenforceable. It is the position of the appellants, however, that s. 36 does not extinguish a debt or liability which they say has been created. The appellants rely on the decision in Re East Chilliwack Agricultural Co-operative (1989), 74 C.B.R. (N.S.) 1, 58 D.L.R. (4th) 11 (B.C.C.A.), in support of their position that a debt or liability is created notwithstanding the solvency requirements of s. 36 respecting payment. The appellants' submission does not take into consideration the major differences between the decision in East Chilliwack and the present situation relating to the timing, effect of the solvency requirements and the provisions in the articles governing the relationship of the parties.

(1) In East Chilliwack, farmers who owned shares in an agricultural co-operative gave notice to the co-op of their intention to have their shares redeemed. After the notices had been given, the superintendent of co-operatives suspended the right of the co-op to redeem its shares. Here, the request to redeem the shares by McCutcheon and the retraction date occurred after Central Capital had sent out a notice that it would not be able to redeem the shares due to its financial position. SYH had no right to demand that its shares be retracted until the retraction date, which was some two years after the date of Central Capital's insolvency.

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

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

Here, the effect of Central Capital's inability to redeem its shares due to insolvency is very much in issue and cannot be ignored. Although the articles provide for the redemption of all of the shares held by McCutcheon and SYH on or after the retraction date, the articles also state that Central Capital will only redeem so many of its shares as would not be "contrary to law". Pursuant to s. 36(1) of the CBCA, a corporation may purchase or redeem redeemable shares, but the corporation is prohibited from doing so if the corporation is unable to pay its liabilities as they become due or if the assets of the corporation are less than the total of its liabilities and the amount required for the redemption. Because Central Capital could not comply with the solvency requirements, redemption would be "contrary to law".

(2) In East Chilliwack, supra, at p. 13, the rules of the co-op provided that upon the giving of a notice of redemption, the farmer giving it ceased to be a shareholder. Central Capital's articles do not state that a request

for redemption of the holder's shares terminates his status as a shareholder. McCutcheon continued to have the right to receive dividends pursuant to art. 4.5 while his shares were not redeemed. In effect, so long as Central Capital was unable to redeem the shares but had profits, McCutcheon continued to be entitled to a share of the profits through the declaration of dividends. If the dividends remained unpaid for eight consecutive quarters then, pursuant to art. 8, McCutcheon had the right to receive notice of, and to attend, each meeting of shareholders at which directors were to be elected and was entitled to vote for the election of two directors. The articles relating to the preferred shares held by SYH contain a similar provision. The result of insolvency as envisaged by the articles was that McCutcheon and SYH would continue as shareholders.

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

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

(4) Article 8 and a similar provision in the articles relating to the shares held by SYH provide that upon a sale of all or a substantial part of the company's undertaking, the preferred shareholders have a right to receive notice of and to be present at the meeting called to consider this sale. The farmers in East Chilliwack do not appear to have had any similar right.

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

Nothing in the articles concerning the retraction date affects the right of McCutcheon and SYH to participate in Central Capital's liquidation. The participation of the farmer in East Chilliwack ceased once he had given notice to redeem. Article 4.4 of Central Capital provides that once the shares have been tendered for retraction this election is irrevocable on the part of the holder. In the event that payment of the retraction price was not made, however, the holder had the right to have all deposited share certificates returned. Central Capital offered to return McCutcheon's shares to him, but he refused. Because McCutcheon retained all the rights and privileges of a preferred shareholder after the retraction date, the fact that he refused to take back his share certificates cannot alter the true nature of the relationship. The refusal was merely evidence of a dispute concerning what the relationship was. SYH also retained its full status as a shareholder until the date of the reorganization. This was not the situation in East Chilliwack.

By way of summary, on the date of the reorganization McCutcheon and SYH had not ceased to be preferred shareholders of Central Capital. The rights attaching to their retractable preferred shares entitled them to continue to share in the profits of the company when these were declared as dividends, to vote at shareholders meetings to elect directors so long as dividends remained unpaid for a specified period of time, and, on a winding-up of the company, to participate in the distribution of assets that remained after the creditors were paid according to the ranking of the series of their shares. The company's obligation to redeem its shares was not absolute. Instead, the articles provided for what was realistically a "best efforts" buy-back based on solvency and continuation as a shareholder to the extent a buy-back could not take place. In East Chilliwack, because the farmer ceased to be a shareholder, the articles do not appear to make any provision for continued participation or for the postponement of payment depending on the solvency of the co-op.

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

Looked at another way, after the retraction date and at the time of the reorganization, the common features of a debtor-creditor relationship are not in evidence in Central Capital's articles. The agreements between the parties contain no express provision that the redemption of the shares is in repayment of a loan. The corporation was not obliged to create any fund or debt instrument to ensure that it could redeem the shares on the retraction date.

There is no indemnity in the event that the money is not repaid on the retraction date. There is no provision for the payment of any interest after the retraction date in the event that the money is not repaid on the retraction date. There is no provision that after the retraction date and in the event of insolvency, the appellants would have the right to have the company wound up. (See R. v. Imperial General Properties Ltd., [1985] 2 S.C.R. 288, 21 D.L.R. (4th) 741, for a case where the articles of the company contained this right.) There is no provision that upon a winding-up or insolvency the parties are entitled to rank pari passu with the creditors as was the case in Canada Deposit Insurance Corp. v. Canadian Commercial Bank, supra.

(d) The effect of the reorganization

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

The appellants submit that a winding-up or liquidation is not the same as a reorganization. This is true. Both, however, are methods of dealing with insolvency. Both are methods for secured creditors to enforce their claims by seizing the assets in which they hold security interests. If the value of the corporation as a going concern exceeds the liquidation value of the assets, it is in the interest of all the debt holders that the corporation be preserved as a going concern. The purpose of both a liquidation and a reorganization is to permit the rehabilitation of the insolvent person unfettered by debt: Vachon v. Canada Employment & Immigration Commission, [1985] 2 S.C.R. 417, 23 D.L.R. (4th) 641. By virtue of s. 20 of the CCAA, arrangements under the Act mesh with the reorganization provisions of the CBCA so as to affect the company's relations with its shareholders. Shareholders have no right to dissent to a reorganization: s. 191(7), CBCA. On a reorganization, among other things, the articles may be amended to alter or remove rights and privileges attaching to a class of shares and to create new classes of shares: s. 173, CBCA. These statutory provisions provide a clear indication that, on a reorganization, the interests of all shareholders, including shareholders with a right of redemption, are subordinated to the interests of the creditors. Where the debts exceed the assets of the company, a sound commercial result militates in favour of resolving this problem in a manner that allows creditors to obtain repayment of their debt in the manner which is most advantageous to them.

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

Dividends

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

Article 7 of Central Capital respecting McCutcheon's shares states that in the event of a liquidation, dissolution or winding-up of the corporation, the shareholders are entitled to receive not only the $25 per Series B preferred share, but "all accrued and unpaid dividends thereon, whether or not declared . . . before any amount is paid by the Corporation or any assets of the Corporation are distributed to the holders of any shares . . . ranking as to capital junior to the Series B Senior preferred Shares".

It is trite law that a dividend may only be declared if a company is solvent. For corporations governed by the CBCA, it appears that the common law tests for solvency have all been subsumed or overruled: R. v. McClurg, [1990] 3 S.C.R. 1020 at pp. 1039-40, [1991] 2 W.W.R. 244 at pp. 259-60.

Section 42 of the CBCA provides:

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

Section 42 prevents the corporation from declaring or paying a dividend when it does not meet certain solvency requirements. There was no declaration of a dividend in the present case. Any obligation to pay a dividend as part of the retraction price cannot therefore be enforced when the company is insolvent. Dividends which have accrued but which are unpaid are not considered to be a debt because, on reading the articles as a whole, the provision for payment is not one which is made independent of the ability to pay: see Welling, supra, at p. 689, citing International Power Co. v. McMaster University, [1946] S.C.R. 178, [1946] 2 D.L.R. 81, where it was held there was no guarantee of payment and hence the accrued but unpaid dividends were not a debt. Instead, accrued but unpaid dividends are considered to be akin to a return of capital. Making these accrued dividends part of the retraction price does not alter this.

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

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

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

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

The Meaning of Debt

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

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

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

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

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

Section 40 does not include any reference to the obligation of a company to repurchase redeemable shares under s. 36. As a result s. 36 is not incorporated by reference into the definition of liability. While it might be suggested that this is a legislative oversight, the omission is also consistent with the position that only the articles of the corporation govern the relationships between the company and the holders of the retractable shares under s. 36. I have already stated my opinion that the articles of Central Capital do not make the obligation to redeem the shares a debt or, for that matter, a liability. Moreover, even if a provision like s. 40 is implied with respect to redeemable preferred shares, it would also be necessary to imply a provision like s. 40(3) which states that in the event of liquidation where the company has not performed its contract to redeem, the other party is entitled to be ranked subordinate to the rights of creditors but in priority to the shareholders. This is a clear expression of legislative intention that on insolvency the claim of those entitled to have their shares redeemed should not be placed on the same footing with the claims of creditors but should rank subordinate to them: see Nelson v. Rentown Enterprises Inc., [1994] 4 W.W.R. 579, 16 Alta. L.R. (3d) 212 (C.A.), adopting the reasons of Hunt J. at 96 D.L.R. (4th) 586, 5 Alta. L.R. (3d) 149 (Q.B.). Policy reasons would again militate in favour of the result being the same on a reorganization.

Claims in Bankruptcy

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

Persuasive authority already exists to the effect that in order to be a provable claim within the meaning of s. 121 of the Bankruptcy and Insolvency Act the claim must be one recoverable by legal process: Farm Credit Corp. v. Holowach (Trustee of), [1988] 5 W.W.R. 87 at p. 90, 51 D.L.R. (4th) 501 (Alta. C.A.), leave to appeal to the Supreme Court of Canada dismissed at [1989] 4 W.W.R. lxx.

In Holowach, the seven members of the court were dealing with a situation in which some persons borrowed money from a mortgagee and mortgaged certain lands as security for repayment of the loan. The mortgagors then made an assignment in bankruptcy. The mortgagee filed a proof of claim for the full amount of the deficiency, that is, the amount of the indebtedness less the value of the land which the mortgagee was permitted to purchase. The Alberta Law of Property Act, R.S.A. 1980, c. L-8, precluded deficiency claims against individuals in foreclosure actions, although the effect of the legislation was not to extinguish or satisfy the debt. The mortgagee argued that it had a claim provable in bankruptcy under s. 95(1) of the Bankruptcy Act, R.S.O. 1970, c. B-3, now s. 121(1) of the Bankruptcy and Insolvency Act. The court rejected this argument, holding that a provable claim must be one recoverable by legal process. In coming to its conclusion, the court relied on Reference re Debt Adjustment Act, 1937, [1943] 1 All E.R. 240, [1943] 1 W.W.R. 378 (P.C.), and a number of decisions at the trial level which are collected at p. 91 of the decision.

Here, the contract to repurchase the shares, while perfectly valid, is without effect to the extent that there is a conflict between the corporation's promise to redeem the shares and its statutory obligation under s. 36 of the CBCA not to reduce its capital where it is insolvent. As was the case in the Holowach decision, this statutory overlay renders Central Capital's promise to redeem the appellants' preferred shares unenforceable. Although there is a right to receive payment, the effect of the solvency provision of the CBCA means that there is no right to enforce payment. Inasmuch as there is no right to enforce payment, the promise is not one which can be proved as a claim.

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

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

CONCLUSION

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

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

The Issue

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

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

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

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

On June 15, 1992, Houlden J. provided that Central Capital could be reorganized under the Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, and he stayed proceedings against it. Houlden J.'s order of July

9, 1992, which approved the restructuring of Central Capital, was made without prejudice to the right of the appellants to assert claims as creditors. Thus the question for this court is whether the appellants' retraction rights created debts of Central Capital in May 1992. In other words were McCutcheon and SYH Corporation creditors of Central Capital in May 1992? If they were creditors, then like the other unsecured creditors of Central Capital, they can elect to take shares in the newly incorporated company, Canadian Insurance Group Limited; if they were not creditors, then they remain shareholders of Central Capital under the restructuring plan.

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

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

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

I. The Relationship Between the Appellants and Central Capital

Preferred shares have been called "compromise securities" and even "financial mongrels": Grover and Ross, Materials and Corporate Finance (1975), at p. 49. Invariably the conditions attaching to preferred shares contain attributes of equity and, at least in an economic sense, attributes of debt. Over the years financiers and corporate lawyers have blurred the distinction between equity and debt by endowing preferred shareholders with rights analogous to the rights of creditors. One example is the right of redemption -- the right of the corporation to compel preferred shareholders to sell their shares back to the corporation. Another example, and it is the case before us, is the right of retraction -- the right of shareholders to compel the corporation to buy back their shares on a specific date for a specific price.

I acknowledge, therefore, that redeemable or retractable preferred shares are somewhat different from conventional equity capital. What makes the appeals before us difficult is that although the appellants appear to hold equity, their right of retraction appears to be a basic characteristic of a debtor-creditor relationship: see Grover and Ross, supra, at pp. 47-49; Buckley, Gillen and Yalden, Corporations: Principles and Policies, 3rd ed. (1995), at pp. 938-40.

If the certificate or instrument contains features of both equity and debt -- in other words if it is hybrid in character -- then the court must determine the "substance" of the relationship between the holder of the certificate and the company. This is the lesson of Justice Iacobucci's judgment in Canada Deposit Insurance Corp. v. Canadian Commercial Bank, [1992] 3 S.C.R. 558, 97 D.L.R. (4th) 385. In that case the Supreme Court of Canada had to determine whether the financial assistance given by several lending institutions to try to rescue the Canadian Commercial Bank was "in the nature of a loan" or "in the nature of a capital investment". Justice Iacobucci discussed his approach to the problem at pp. 590-91 of his judgment:

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

main thrust of the agreement.

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

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

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

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

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

(ii) The senior preferred shares and junior preferred shares that the appellants own were part of the authorized capital of Central Capital before the appellants acquired them.

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

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

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

These provisions in the preferred share conditions also state that on payment of the amount owing to them the appellants "shall not be entitled to share in any further distribution of assets of the corporation". Finlayson J.A. interprets this to mean that the appellants "are not entitled to be treated as shareholders under a winding-up or liquidation but only as creditors". I disagree. These are typical preferred share provisions, which limit the recovery of the holders but do not treat them as creditors: Sutherland, Fraser and Stewart on Company Law of Canada, 6th ed. (1993), at p. 198. At least on a liquidation, dissolution or winding-up, the preferred share conditions evidence

that the appellants would be treated not as creditors but as shareholders. In CDIC v. CCB, supra, Iacobucci J. placed considerable weight on a provision in the participation agreement stating that each participant "shall rank pari passu with the rights of the depositors". No such provision exists in this case. Indeed the share conditions I have referred to state the opposite.

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

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

It seems to me that these appellants must be either shareholders or creditors. Except for declared dividends, they cannot be both. Once they are characterized as shareholders, their rights of retraction do not create a debtor-creditor relationship. These rights enable them to call for the repayment of their capital on a specific date (and at an agreed-upon price) provided the company is solvent. Ordinarily shareholders have to recoup their investment by selling their shares to third parties. If they have retraction rights, however, they can compel the company (if solvent) to repay their investment at a given time for a given price. But the right of retraction provides for the return of capital not for the repayment of a loan. Certainly the Canada Business Corporations Act treats a redemption of shares as a return of capital because s. 39 of the statute requires a company on a redemption to deduct from its stated capital account an amount equal to the value of the shares redeemed. The shares redeemed are then either cancelled or returned to the status of authorized but unissued shares.

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

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

Admittedly there is little authority in Canada on the issue confronting this court. Some of the cases that the respondent relies on -- for example, Re Patricia Appliance Shops Ltd. (1922), 52 O.L.R. 215, [1923] 3 D.L.R. 1160 (S.C.), Laronge Realty Ltd. v. Golconda Investments Ltd. (1986), 63 C.B.R. (N.S.) 74, 7 B.C.L.R. (2d) 90 (C.A.), and even Re Meade, [1951] 2 All E.R. 168, [1951] Ch. 774 (D.C.) -- are of limited assistance because the shareholders in those cases did not have retraction rights.

Perhaps the closest case -- and the appellants rely heavily on it -- is the judgment of the British Columbia Court of Appeal in Re East Chilliwack Agricultural Co-operative (1989), 74 C.B.R. (N.S.) 1, 58 D.L.R. (4th) 11. In that case a majority of the court (Craig J.A. dissenting) held that a withdrawing member of a co-operative association who elected to have his shares redeemed in instalments over a five-year period should be treated on the subsequent bankruptcy of the association as an ordinary creditor rather than as a shareholder. I decline to apply East Chilliwack for three reasons. First, because the case was decided in 1989, the British Columbia Court of Appeal did not have the benefit of the Supreme Court of Canada's reasons in CDIC v. CCB, supra. In East Chilliwack Hutcheon J.A., writing for the majority, did not focus on what the parties intended when the member

contracted with the co-operative. Instead he only considered the relationship between the member and the co-operative after the member had withdrawn. I do not think his approach is consistent with Justice Iacobucci's judgment in CDIC v. CCB, supra.

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

Third, the decision in East Chilliwack is at odds with most of the American case-law and I favour the American approach. When a company repurchases shares by instalment and bankruptcy intervenes, the prevailing American position is that the shareholder's claim is deferred to the claims of ordinary creditors. The decision of the Fifth Circuit Court of Appeals in Robinson v. Wangemann, 75 F.2d 756 (1935), is frequently cited. The facts of that case are virtually identical to the facts in East Chilliwack. A company had agreed to repurchase a stockholder's stock by instalments. Although the company was solvent when the agreement was made it went bankrupt before the repurchase was completed. The stockholder sought to prove as an ordinary creditor for the unpaid purchase price. Foster, Circuit Judge, writing for a unanimous court, rejected the stockholder's claim at p. 757:

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

At the heart of Robinson v. Wangemann is the finding that the selling stockholder is not a creditor in the sense of a person who loans money to a corporation, and therefore is not entitled to parity with the general creditors. The principle in Robinson v. Wangemann seeks to protect creditors by refusing to permit selling stockholders, who were risk investors, to withdraw their capital on the same terms as general creditors in the event of insolvency. Section 40(3) of the Canada Business Corporations Act -- a section to which I shall return when considering s. 36(2) of the same statute -- codifies the principle in Robinson v. Wangemann for share repurchases, though not for share redemptions. See also Blumberg, The Law of Corporate Groups (1987), at pp. 205-10 and see contra Wolff v. Heidritter Lumber Co., 163 A. 140 (N.J.Ch., 1932).

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

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

> Holders of preferred stock of a corporation, in the absence of express provision to the contrary, are stockholders and not creditors of the corporation, except for dividends declared. They have no lien upon, and are not entitled to, any of the assets of the corporation when it becomes insolvent,

> until all debts are paid. Furthermore, there is authority that the status of a preferred stockholder is not changed to that of creditor, even though a dividend is guaranteed. Indeed it is beyond the power of a corporation to issue a class of stock, the holders of which are entitled to preference over general creditors.
>
> . . . . .
>
> Even where preferred stock has a fixed redemption date, arrival of that date does not change the status of a preferred stockholder to that of a creditor.

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

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

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

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

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

To hold that the appellants have provable claims would defeat the purpose of s. 36(2) of the Canada Business Corporations Act. At common law a company could not repurchase its own shares on the open market or in the language of Trevor v. Whitworth (1887), 12 App. Cas. 409, [1886-90] All E.R. Rep. 46 (H.L.), a company could not "traffick in its own shares". The obvious reason was to prevent companies from using their assets to destroy the claims of their creditors. Modern corporate statutes, such as the Canada Business Corporations Act, modified the rule in Trevor v. Whitworth to permit repurchases provided the company's creditors would not be prejudiced. Thus the legislation insisted that the company could not repurchase its own shares unless it satisfied stated solvency tests. And so, s. 34(2) of the Canada Business Corporations Act provides:

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

In Nelson v. Rentown Enterprises Inc. (1993), 96 D.L.R. (4th) 586 at p. 589, 5 Alta. L.R. (3d) 149, affirmed (1994), 109 D.L.R. (4th) 608n, 16 Alta. L.R. (3d) 212 (C.A.), Hunt J. of the Alberta Queen's Bench wrote:

The policy behind the s. 34(2) limitation upon a corporation's power to purchase its own shares seems obvious. It is intended to ensure that one or more shareholders in a corporation do not recoup their investments to the detriment of creditors and other shareholders. It has been observed that:

> Corporate power to purchase its own stock has been frequently abused. Done by corporations conducting faltering businesses, it has been employed to create preferences to the detriment of creditors and of the other stockholders.

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

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

Redemptions of preferred shares, unlike repurchases, were always permitted at common law as long as they were not made in contemplation of bankruptcy. But the solvency test in s. 36(2) of the Canada Business Corporations Act has the same purpose as the solvency test in s. 34(2): to prevent redemptions if they would allow the company to prejudice the claims of creditors. See Buckley et al., Corporations: Principles and Policies, supra, at pp. 968-71. To hold that the appellants' retraction rights gave rise to provable claims in the face of s. 36 (2), thereby allowing the appellants to rank equally with the unsecured creditors, would undermine the purpose of the section. If a claim in a bankruptcy or reorganization proceeding is unenforceable under the statute, the claim is not entitled to recognition on a parity with the claims of unsecured creditors: see Blumberg, supra, at pp. 205-06; and Farm Credit Corp. v. Holowach (Trustee of) (1988), 68 C.B.R. (N.S.) 255, 51 D.L.R. (4th) 501 (Alta. C.A.).

I draw comfort in this conclusion from s. 40 of the Canada Business Corporations Act. Section 40(1) provides that a contract with a corporation for the purchase of its shares is specifically enforceable against the corporation "except to the extent that the corporation cannot perform the contract without thereby being in breach of s. 34". Section 40(3) then states:

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

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

The appellants rely on The Custodian v. Blucher, [1927] S.C.R. 420, [1927] 3 D.L.R. 40, but in my view this case does not assist them. In Blucher dividends were declared on stock but payment of the dividends was suspended during World War I. The Supreme Court of Canada held at p. 425 S.C.R., p. 43 D.L.R. that "[t]he right of recovery was in suspense during the war; but the debt nevertheless existed". In that case, however, the dividend was declared before the suspension of payment took place. Moreover, as Justice Finlayson points out in his reasons, courts have always accepted the proposition that when a dividend is declared it is a debt on which each shareholder can sue the corporation.

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

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

Order accordingly.

Note 1: There is a discrepancy in the materials before this court on the relevant date for establishing a claim provable against Central Capital: SYH Corporation used May 1992, the date of the restated subscription and escrow agreement whereas McCutcheon and the unsecured creditors of Central Capital Corporation used June 15, 1992, the date of the court-ordered stay of proceedings against Central Capital. I have used the May 1992 date but nothing turns on the use of this date as opposed to the June 15, 1992 date.

Tab 4

Case Name:

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.

[2010] O.J. No. 4903

2010 ONSC 6229

75 B.L.R. (4th) 302

71 C.B.R. (5th) 153

2010 CarswellOnt 8655

Court File No. 10-8630-00CL

Ontario Superior Court of Justice
Commercial List

S.E. Pepall J.

November 16, 2010.

(36 paras.)

Bankruptcy and insolvency law -- Companies' Creditors' Arrangement Act (CCAA) -- Compromises and arrangements -- Claims -- Priority -- Motion by the holders of promissory notes from the debtor company for an order that all claims and potential claims of the preferred shareholders against the company be classified as equity claims within the meaning of the Companies' Creditors Arrangement Act allowed -- Claims of preferred shareholders for unpaid dividends, redemption, compensatory damages and rescission fell within s. 2 of the Companies' Creditors Arrangement Act and were thus equity claims.

Motion by the holders of promissory notes from the debtor company for an order that all claims and potential claims of the preferred shareholders against the company be classified as equity claims within the meaning of the Companies' Creditors Arrangement Act. The company raised money from investors and then used those funds to extend credit to customers in vendor assisted financing programmes. It issued promissory notes or preference shares to the investors. The preferred shareholders were entered on the share register and received share certificates. They were treated as equity in the company's financial statements. The claims of the preferred shareholders against the company were for declared but unpaid dividends, unperformed requests for redemption, compensatory damages for negligent or fraudulent misrepresentation and payment of the amounts due upon the rescission or annulment of the purchase or subscription for preferred shares.

HELD: Motion allowed. The preferred shareholders were shareholders of the company, not creditors. The substance of the arrangement between the preferred shareholders and the company was a relationship based on equity and not debt. The claims of the preferred shareholder in the present case did not constitute a claim

provable for the purposes of the Companies' Creditors Arrangement Act. The language of s. 2 of the Act was clear and unambiguous and equity claims included a claim in respect of an equity interest and a claim for a dividend or similar payment and a claim for rescission. This encompassed the claims of all of the preferred shareholders.

Statutes, Regulations and Rules Cited:

Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3, s. 2, s. 121(1)

Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, s. 2, s. 6(8), s. 22.1

Counsel:

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

J.H. Grout and S. Aggarwal, for the Monitor.

Pamela Foy, for the Ontario Securities Commission.

Frank Lamie, for Nelson Financial Group Ltd.

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

Michael Beardsley, Self Represented Respondent.

Clifford Holland, Self Represented Respondent.

Arnold Bolliger, Self Represented Respondent.

John McVey, Self Represented Respondent.

Joan Frederick, Self Represented Respondent.

Rakesh Sharma, Self Represented Respondent.

Larry Debono, Self Represented Respondent.

Keith McClear, Self Represented Respondent.

REASONS FOR DECISION

1 S.E. PEPALL J.:-- 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%.[1] 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 non-compliance 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 *Re Central Capital Corporation*[2], 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: *Re Blue Range Resource Corp.*[3] 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 *Re Stirling Homex Corp.*[4] 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.*[5] and *Earthfirst Canada Inc.*[6] 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 *Re Central Capital Corporation*[7]. 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 case, 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 creditors. 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 creditors. 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*, it is implicit that they therefore would rank behind creditors.
(d) Although I acknowledge 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.*[8], 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 claims 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.*[9] 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[10], 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.

S.E. PEPALL J.

cp/e/qlafr/qlvxw/qlana

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

2 (1996), 38 C.B.R. (3d) 1 (Ont. C.A.).

3 (2000), 15 C.B.R. (4th) 169.

4 (1978) 579 F. 2d 206 (2nd Cir. Ct. of App.).

5 [2001] A.J. No. 918, (2001), 2001 CarswellAlta 913, aff'd [2002] A.J. no. 6, 2002 CarswellAlta 23 (Alta C.A.).

6 [2009] A.J. No. 749, (2009) 2009 CarswellAlta 1069.

7 Supra, note 2.

8 [2008] O.J. No. 885, (2008), 2008 CarswellOnt 1245.

9 Supra, note 5.

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

Tab 5

Case Name:

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.

[2009] A.J. No. 749

2009 ABQB 316

56 C.B.R. (5th) 102

2009 CarswellAlta 1069

Docket: 0801 13559

Registry: Calgary

Alberta Court of Queen's Bench
Judicial District of Calgary

B.E.C. Romaine J.

Heard: May 13, 2009.
Judgment: May 27, 2009.

(5 paras.)

Counsel:

Kelly J. Bourassa and Scott Kurie, for Indemnity Claimants of Earthfirst Canada Inc.

Howard A. Gorman, for Earthfirst Canada Inc.

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

[Editor's note: A corrigendum was released by the Court on July 8, 2009; the corrections have been made to the text and the corrigendum is appended to this document.]

Reasons for Judgment

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

FACTS

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

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

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

ISSUE

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

ANALYSIS

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

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

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

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

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

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

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

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

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

The Court of Appeal in dismissing the appeal commented:

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

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

(a) a dividend or similar payment,
(b) a return of capital,
(c) a redemption or retraction obligation,

(d) a monetary loss resulting from the ownership, purchase or sale of an equity interest or from the rescission, or, in Quebec, the annulment, of a purchase or sale of an equity interest, or

(e) contribution or indemnity in respect of a claim referred to in any paragraphs (a) to (d) [emphasis added].

CONCLUSION

I therefore grant:

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

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

B.E.C. ROMAINE J.

* * * * *

Corrigendum

Released: July 8, 2009

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

cp/e/qlcct/qlpwb/qlltl/qlaxr

Tab 6

Office of the Superintendent of Bankruptcy Canada
An Agency of Industry Canada

Bureau du surintendant des faillites Canada
Un organisme d'Industrie Canada

Canada

Office of the Superintendent of Bankruptcy Canada

First Previous Next Last

Bill C-12: Clause by Clause Analysis — Clauses 71-80

An Act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act, the Wage Earner Protection Program Act and chapter 47 of the Statutes of Canada, 2005

Amendments to the *Companies' Creditors Arrangement Act* (CCAA)	Clauses of Bill C-12	Sections
Voting by Equity Claimants	71	s.22.1
Voting by Related Parties	71	s.22
Duties and Functions of Monitors	72	s.23(1)
Compilation of Information	73	s.26(3)
Rights during Investigations	74	s.29(2)
Subpoena or Summons	75	s.30(3)
Disclaimer of Agreements	76	s.32
Ipso Facto Clauses	77	s.34
BIA Provisions	78	s.36.1
Sale of Assets	78	s.36
Crown Securities	79	s.39(1)
Forms of Cooperation	80	s.52(3)

Bill Clause No. 71
Section No. CCAA s.22.1
Topic: Voting by Equity Claimants

Proposed Wording

22.1 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.

Rationale

The amendment is one of several made with the intention of clarifying that equity claims are to be subordinate to other claims. Equity claims are ownership interests and, as such, should be subject to the risks of insolvency. It is possible, however, that in some restructurings it would be appropriate for the equity claimants to have a vote - for example, where they are the only creditors - and therefore judicial discretion is provided to the court to allow this to happen in the appropriate circumstances.

Section 22.1 is added to clarify that unless the court orders otherwise, holders of equity claims should be in the same class in respect of those claims and should be prevented from voting those claims at any meeting.

Present Law

None.

Bill Clause No. 71
Section No. CCAA s.22
Topic: Voting by Related Parties

Proposed Wording

22.(1) A debtor company may divide its creditors into classes for the purpose of a meeting to be held under section 4 or 5 in respect of a compromise or an arrangement relating to **the** company and, if it does so, it **is to** apply to the court for approval of the division before **the** meeting is held.

(2) For the purpose of subsection (1), creditors may be included in the same class if their interests **or rights** are sufficiently similar to give them a commonality of interest, taking into account

(*a*) the nature of the debts, liabilities or obligations giving rise to their claims;
(*b*) the nature and rank of any security in respect of their claims;
(*c*) the remedies available to the creditors in the absence of the compromise or arrangement being sanctioned, and the extent to which the creditors would recover their claims by exercising those remedies; and
(*d*) any further criteria, consistent with those set out in paragraphs (*a*) to (*c*), that are prescribed.

(3) **A creditor who is related to the debtor company may vote against, but not for, a compromise or an arrangement relating to the company**.

Rationale

Section 22 sets out the rules regarding the division of creditors into classes for the purpose of voting at a meeting of creditors.

Subsections (1) and (2) have been amended for readability.

Subsection (3) has been added to parallel the voting system in the BIA proposal provisions. Parties related to the debtor company will no longer be entitled to vote in favour of a plan, only against it. This should reduce the ability of debtor companies to organize a restructuring plan that confers additional benefits to related parties.

Present Law

As enacted by Chapter 47, Clause 131:

22.(1) Subject to subsection (3), a debtor company may divide its creditors into classes for the purpose of a meeting to be held under section 4 or 5 in respect of a compromise or an arrangement relating to a company and, if it does so, it must apply to the court for approval of the division before any meeting is held.

(2) For the purpose of subsection (1), creditors may be included in the same class if their interests are sufficiently similar to give them a commonality of interest, taking into account

(*a*) the nature of the debts, liabilities or obligations giving rise to their claims;
(*b*) the nature and rank of any security in respect of their claims;
(*c*) the remedies available to the creditors in the absence of the compromise or arrangement being sanctioned, and the extent to which the creditors would recover their claims by exercising those remedies; and

(*d*) any further criteria, consistent with those set out in paragraphs (*a*) to (*c*), that are prescribed.

(3) Creditors having a claim against a debtor company arising from the rescission of a purchase or sale of a share or unit of the company — or a claim for damages arising from the purchase or sale of a share or unit of the company — must be in the same class of creditors in relation to those claims and may not, as members of that class, vote at a meeting to be held under section 4 in respect of a compromise or an arrangement relating to the company.

Bill Clause No. 72
Section No. CCAA s.23(1)
Topic: Duties and Functions of Monitors

Proposed Wording

23.(1)(*a*)(ii) within five days after the **day on which the** order is made,

(A) make the order publicly available in the prescribed manner,
(**B**) send, **in the prescribed manner**, a **notice** to every known creditor who has a claim against the company of more than $1,000 **advising them that the order is publicly available**, and
(**C**) **prepare** a list, showing the **names** and **addresses** of those creditors **and the estimated amounts of those claims, and make it** publicly available in the prescribed manner;

[...]

(*d*) file a report with the court on the state of the company's business and financial affairs — containing **the** prescribed information, **if any** —

(i) without delay after ascertaining **a** material adverse change in the company's projected cash-flow or financial circumstances,
(**ii**) not later than 45 days, or any longer period that the court may specify, after the **day on which** each of the company's fiscal quarters **ends**, and
(**iii**) at any other **time** that the court may order;

(*d.1*) file a report with the court on the state of the company's business and financial affairs — containing the monitor's opinion as to the reasonableness of a decision, if any, to include in a compromise or arrangement a provision that sections 38 and 95 to 101 of the *Bankruptcy and Insolvency Act* do not apply in respect of the compromise or an arrangement and containing the prescribed information, if any — at least seven days before the day on which the meeting of creditors referred to in section 4 or 5 is to be held;
(*e*) advise the company's creditors of the filing of the report referred to in any of paragraphs (*b*) to (*d.**1***);
(*f*) file with the Superintendent of Bankruptcy, **in the prescribed manner and at the prescribed time**, a copy of the documents specified **in** the regulations;
(*f.1*) for the purpose of defraying the expenses of the Superintendent of Bankruptcy incurred in performing his or her functions under this Act, pay the prescribed levy at the prescribed time to the Superintendent for deposit with the Receiver General;

[...]

(*j*) make the **prescribed** documents publicly available in the prescribed manner **and at the prescribed time** and provide the company's creditors with information as to how they may access those documents; and [.....]

[...]

(2) If the monitor acts in good faith and takes reasonable care in preparing the report referred to in any of paragraphs (1)(*b*) to (***d.1***), the monitor is not liable for loss or damage to any person resulting from that person's reliance on the report.

Rationale

Paragraph (*a*) is amended to clarify that only a notice of the initial application order must be provided to creditors. Chapter 47 inadvertently stated that the order itself needed to be sent to each creditor. Further, the paragraph is amended to require that the estimated amount of each creditor's claim be listed. The list is intended to assist creditors as they prepare for creditors' meetings. Without information relating to the amounts, the list will be of limited value since creditors' votes at meetings are based on their claims.

Paragraph (*d*) is amended in order to clarify that even in the absence of prescribed information in the regulations, the monitor must nevertheless file a report on the state of the company's business and financial affairs with the court. In addition, subparagraph (1)(d)(ii) of Chapter 47 has been removed and added to paragraph (*d.1*).

Paragraph (*d.1*) specifies the information that the monitor must report to the court. The intention of the paragraph is to ensure that creditors receive the notice and information in a timely manner for them to be in a position to make an informed decision at the meeting.

The change in paragraph (*e*) is a technical amendment to correct cross-referencing as a result of the addition of paragraph (*d.1*) to the section.

Paragraph (*f*) is amended to clarify that the documents should be filed as prescribed by regulations.

Paragraph (*f.1*) is added to clarify the rationale for the fee.

Paragraph (*j*) is amended to clarify that the time for filing of prescribed documents may be prescribed by regulations.

Subsection (2) is amended to correct cross-referencing.

Present Law

As enacted by Chapter 47, Clause 131:

23.(1)(a)(ii) within five days after the order is made,

(A) send a copy of the order to every known creditor who has a claim against the company of more than $1,000, and
(B) make a list showing the name and address of those creditors publicly available in the prescribed manner;

[...]

(*d*) file a report with the court on the state of the company's business and financial affairs, containing prescribed information,

(i) without delay after ascertaining any material adverse change in the company's projected cash-flow or financial circumstances,
(ii) at least seven days before any meeting of creditors under section 4 or 5,
(iii) not later than 45 days, or any longer period that the court may specify, after the end of each of the company's fiscal quarters, and
(iv) at any other times that the court may order;

(*e*) advise the company's creditors of the filing of the report referred to in any of paragraphs (*b*) to (*d*);

(*f*) file with the Superintendent of Bankruptcy a copy of the documents specified by the regulations and pay the prescribed filing fee;

[...]

(*j*) unless the court otherwise orders, make publicly available, in the prescribed manner, all documents filed with the court, and all court decisions, relating to proceedings held under this Act in respect of the company and provide the company's creditors with information as to how they may access those documents and decisions; and

(2) If the monitor acts in good faith and takes reasonable care in preparing the report referred to in any of paragraphs (1)(*b*) to (*d*), the monitor is not liable for loss or damage to any person resulting from that person's reliance on the report.

Bill Clause No. 73
Section No. CCAA s.26(3)
Topic: Compilation of Information

Proposed Wording

26.(3) The Superintendent of Bankruptcy may enter into an agreement to provide a compilation of all or part of the information that is contained in the public record.

Rationale

The amendment clarifies that the Superintendent of Bankruptcy has the authority to enter into agreements to provide compilations of information maintained in the public record to third parties.

Present Law

None.

Bill Clause No. 74
Section No. CCAA s.29(2)
Topic: Rights During Investigations

Proposed Wording

29.(2) For the purpose of the inquiry or investigation, the Superintendent of Bankruptcy or any person whom he or she appoints for the purpose

> (*a*) shall have access to and the right to examine and make copies of **the** books, records, data, documents **or** papers — including **those** in electronic form — in the possession or under the control of a monitor under this Act; and
> (*b*) may, with the leave of the court granted on an *ex parte* application, examine the books, records, data, documents **or** papers — including **those** in electronic form — relating to any compromise or arrangement **in respect of** which this Act applies that are in the possession or under the control of any other person designated in the order granting the leave, and for that purpose may under a warrant from the court enter and search any premises.

French version only:

29.(3) Le surintendant des faillites peut retenir les services des experts ou autres personnes et du personnel administratif dont il estime le concours utile **à** l'investigation ou l'enquête et fixer leurs

fonctions et leurs conditions d'emploi. La rémunération et les indemnités dues **à** ces personnes sont, une fois certifiées par le surintendant, **imputables** sur les crédits affectés à son bureau.

Rationale

Subsection (2) is amended to correct a drafting error created by Chapter 47, which could be interpreted to mean that only electronic "data" were to be subject to a production order, while electronic books, records and papers were not. The amendment clarifies the policy intention to include all materials under a production order, including those in electronic form.

Subsection (3) of the French version of the Act is amended by replacing the word "payables" with "imputables" as it more accurately reflects the concept of payment from an appropriation.

Present Law

As enacted by Chapter 47, Clause 131:

29.(2) For the purpose of the inquiry or investigation, the Superintendent of Bankruptcy or any person whom he or she appoints for the purpose

> (*a*) shall have access to and the right to examine and make copies of all books, records, data, including data in electronic form, documents and papers in the possession or under the control of a monitor under this Act; and
> (*b*) may, with the leave of the court granted on an *ex parte* application, examine the books, records, data, including data in electronic form, documents and papers relating to any compromise or arrangement to which this Act applies that are in the possession or under the control of any other person designated in the order granting the leave, and for that purpose may under a warrant from the court enter and search any premises.

French version only:

(3) Le surintendant des faillites peut retenir les services des experts ou autres personnes et du personnel administratif, dont il estime le concours utile pour l'investigation ou l'enquête et fixer leurs fonctions et leurs conditions d'emploi. La rémunération et les indemnités dues de ces personnes sont, une fois certifiées par le surintendant, payables sur les crédits affectés à son bureau.

Bill Clause No. 75
Section No. CCAA s.30(3)
Topic: Subpoena or Summons

Proposed Wording

30.(3) The Superintendent of Bankruptcy may, for the purpose of the hearing, issue a summons requiring **the** person named in it

> (*a*) to appear at the time and place mentioned in it;
> (*b*) to testify to all matters within **their** knowledge relative to the subject matter of the inquiry or investigation into the conduct of the monitor; and
> (*c*) to bring and produce any books, records, data, documents or papers — including **those** in electronic form — in **their** possession or under **their** control relative to the subject matter of the inquiry or investigation.

(4) A person may be summoned from any part of Canada by virtue of a summons issued under subsection (3).

Rationale

Subsection (3) is amended to correct a drafting error created by Chapter 47, which could be interpreted to mean that only electronic "data" were to be subject to a production order, while electronic books, records and papers were not. The amendment clarifies the policy intention to include all materials under a production order, including those in electronic form.

Subsection (4) is amended to correct a divergence between the French term (assignations) and the English terms (subpoena, other request or summons) by modernizing the English version to limit the English version to "summons".

Present Law

As enacted by Chapter 47, Clause 131:

30.(3) The Superintendent of Bankruptcy may, for the purpose of the hearing, issue a subpoena or other request or summons, requiring and commanding any person named in it

(*a*) to appear at the time and place mentioned in it;
(*b*) to testify to all matters within his or her knowledge relative to the subject matter of the inquiry or investigation into the conduct of the monitor; and
(*c*) to bring and produce any books, records, data, including data in electronic form, documents or papers in the person's possession or under the control of the person relative to the subject matter of the inquiry or investigation.

(4) A person may be summoned from any part of Canada by virtue of a subpoena, request or summons issued under subsection (3).

Bill Clause No. 76
Section No. CCAA s.32
Topic: Disclaimer of Agreements

Proposed Wording

32.(1) Subject to **subsections (2) and** (3), a debtor company may — **on** notice **given** in the prescribed **form** and manner to the other parties to the agreement **and the monitor** — disclaim or resiliate any agreement to which **the company** is a party on the day **on which proceedings commence under this Act. The company may not give notice unless the monitor approves the proposed disclaimer or resiliation.**

(**2**) Within 15 days after **the day on which the company gives** notice **under subsection (1)**, a party to the agreement may, on notice to **the other** parties **to the agreement and the monitor**, apply to **a** court for **an order** that the agreement **is not to be disclaimed or resiliated**.

(3) If the monitor does not approve the proposed disclaimer or resiliation, the company may, on notice to the other parties to the agreement and the monitor, apply to a court for an order that the agreement be disclaimed or resiliated.

(4) In deciding whether to make the order, the court is to consider, among other things,

(*a*) whether the monitor approved the proposed disclaimer or resiliation;
(*b*) whether the disclaimer or resiliation **would enhance the prospects of** a viable compromise or arrangement **being** made in respect of the company; and
(*c*) whether the disclaimer or resiliation would likely cause significant financial hardship to a party to the agreement.

(5) An agreement is disclaimed or resiliated

(*a*) if no application is made under subsection (2), on the day that is 30 days after the day on which the company gives notice under subsection (1);
(*b*) if the court dismisses the application made under subsection (2), on the day that is 30 days after the day on which the company gives notice under subsection (1) or on any later day fixed by the court; or
(*c*) if the court orders that the agreement is disclaimed or resiliated under subsection (3), on the day that is 30 days after the day on which the company gives notice or on any later day fixed by the court.

(**6**) If the company has granted **a right to** use intellectual property to a party to **an** agreement, the disclaimer or resiliation does not affect the party's right to use the intellectual property — **including the party's right to enforce an exclusive use — during the term of the agreement, including any period for which the party extends the agreement as of right, as** long as **the** party continues to perform its obligations **under the agreement** in relation to the use of the intellectual property.

(**7**) If an agreement is disclaimed or resiliated, **a** party to the agreement **who suffers a loss in relation to the disclaimer or resiliation** is **considered** to have a **provable** claim.

(8) A company shall, on request by a party to the agreement, provide in writing the reasons for the proposed disclaimer or resiliation within five days after the day on which the party requests them.

(**9**) **This section** does not apply in respect of

(*a*) an eligible financial contract;
(*b*) a collective agreement;
(*c*) a financing agreement if the **company** is the borrower; **or**
(*d*) a lease of real property or **of** an immovable if the **company** is the lessor.

Rationale

Prior to Chapter 47, the CCAA was silent on the ability of a debtor to disclaim an agreement. A judicial practice developed, however, based on inherent jurisdiction that allowed the disclaimer of most kinds of agreements.

The rationale for allowing disclaimers is to facilitate restructurings by granting debtors the ability to repudiate agreements that would threaten its viability if they continued to be bound by them. At the same time, codification of the current practice makes the process more transparent by providing both parties with a better understanding of the rules that apply when considering a disclaimer. The amendments are designed to ensure that the process occurs in an open, fair and expeditious manner.

Subsection (1) is amended to require that notice of a disclaimer only be given if the monitor approves the disclaimer. In addition, notice of disclaimers must be given to the monitor. Approval of the monitor is required to prevent a strategic debtor from using the provision to assist related parties by disclaiming agreements that are profitable for the debtor at their expense. Moreover, because disclaimers will not require court approval unless there is opposition, it is necessary to protect against potential abuse.

Subsection (2) is amended to clarify that notice to have a disclaimer set aside be given to the monitor and other parties to the agreement, if any. The language in Chapter 47 currently could be interpreted to exclude the need for notice to these interested parties.

Subsection (3) is added to provide a debtor with the opportunity to appeal to the courts if a monitor refuses to approve a disclaimer. The provision is needed as monitor approval is required to effect a disclaimer.

Subsection (4) amends the test to be applied by the court in determining whether a disclaimer should be granted. Chapter 47 relied upon a difficult to interpret test that may have created greater

uncertainty. In fact, the test, which was drawn from the commercial lease disclaimer section of the BIA, has been judicially interpreted in an inconsistent manner. By providing the court with legislative guidance, the provision should ensure better transparency and fairness. Further, the guidance ensures that the court will consider the effect on all parties, not just the debtor as the commercial disclaimer section requires.

Subsection (5) has been amended to clarify that the counterparties to a disclaimed agreement are provided with at least 30 days notice of a disclaimer so that they may prepare for the event regardless of how the disclaimer becomes effective, i.e., court order or monitor approval.

The amendment to subsection (6) is to clarify that certain rights to use intellectual property granted under a disclaimed agreement – including rights to exclusive use and to as-of-right extensions – continue to be available to the disclaimed party provided that that party continues to perform its obligations under the agreement.

Subsection (7) has been amended to clarify that a party to a disclaimed agreement who suffers a loss has a provable claim in the proceeding. The subsection was also amended to ensure that the disclaimer does not serve to reduce the priority, if any, enjoyed by the party.

Subsection (8) has been added to ensure that a party receiving the subsection (1) notice of intention to disclaim an agreement is able to obtain, within five days, a written explanation from the debtor as to why the debtor is seeking to end the agreement so that it may make an informed decision as to whether to commence a subsection (3) court application to oppose the disclaimer.

By virtue of Clauses 104(1) and 105 of *An Act to implement certain provisions of the budget tabled in Parliament on March 19, 2007*, which received Royal Assent on June 22, 2007 (Chapter 29), the definition of eligible financial contract referred to in subsection (9)(*a*) is now to be found in s.2 rather than in s.11.05(3). Clause 112(20) of this Act amends subparagraph (9)(a) of Clause 26 to remove reference to the old location of the definition.

Present Law

As enacted by Chapter 47, Clause 131 and amended by Chapter 29:

32.(1) Subject to subsection (3), a debtor company may disclaim or resiliate any agreement to which it is a party on the day of the filing of the initial application in respect of the company by giving 30 days notice to the other parties to the agreement in the prescribed manner.

(2) Subsection (1) does not apply in respect of

(*a*) an eligible financial contract;
(*b*) a collective agreement;
(*c*) a financing agreement if the debtor is the borrower; and
(*d*) a lease of real property or an immovable if the debtor is the lessor.

(3) Within 15 days after being given notice of the disclaimer or resiliation, a party to the agreement may apply to the court for a declaration that subsection (1) does not apply in respect of the agreement, and the court, on notice to any parties that it may direct, shall, subject to subsection (4), make that declaration.

(4) No declaration under subsection (3) shall be made if the court is satisfied that a viable compromise or arrangement could not be made in respect of the company without the disclaimer or resiliation of the agreement and all other agreements that the company has disclaimed or resiliated under subsection (1).

(5) If the company has, in any agreement, granted the use of any intellectual property to a party to the agreement, the disclaimer or resiliation of the agreement does not affect the party's right to use the intellectual property so long as that party continues to perform its obligations in relation to the use of the intellectual property.

(6) If an agreement is disclaimed or resiliated by a company, every other party to the agreement is deemed to have a claim for damages as an unsecured creditor.

Bill Clause No. 77
Section No. CCAA s.34
Topic: Ipso Facto Clauses

Proposed Wording

34.(1) No person may terminate or amend, or claim an accelerated payment or forfeiture of the term under, any agreement, including a security agreement, with a debtor company by reason only that **proceedings commenced** under this Act **or that the company is insolvent**.

(2) If the agreement referred to in subsection (1) is a lease, the lessor may not terminate or amend the lease by reason only that **proceedings commenced** under this Act, **that the company is insolvent** or that the company has not paid rent in respect of any period before the **commencement of those proceedings**.

(3) No public utility may discontinue service to a company by reason only that **proceedings commenced** under this Act, **that the company is insolvent** or that the company has not paid for services rendered or goods provided before the **commencement of those proceedings**.

(4) Nothing in this section is to be construed as

(*a*) prohibiting a person from requiring payments to be made in cash for goods, services, use of leased property or other valuable consideration provided after the **commencement** of **proceedings under this Act**;
(*b*) requiring the further advance of money or credit; or
(*c*) preventing a lessor of aircraft objects under an agreement with the company from taking possession of the aircraft objects

(i) if, after proceedings commence under this Act, the company defaults in protecting or maintaining the aircraft objects in accordance with the agreement,
(ii) 60 days after the day on which proceedings commence under this Act unless, during that period, the company

(A) remedied the default of every other obligation under the agreement, other than a default constituted by the commencement of proceedings under this Act or the breach of a provision in the agreement relating to the company's financial condition,
(B) agreed to perform the obligations under the agreement, other than an obligation not to become insolvent or an obligation relating to the company's financial condition, until the proceedings under this Act end, and
(C) agreed to perform all of the obligations arising under the agreement after the proceedings under this Act end, or

(iii) if, during the period that begins on the expiry of the 60-day period and ends on the day on which proceedings under this Act end, the company defaults in performing an obligation under the agreement, other than an obligation not to become insolvent or an obligation relating to the company's financial condition.

(5) Any provision in an agreement that has the effect of providing for, or permitting, anything that, in substance, is contrary to this section is of no force or effect.

(6) On application by a party to an agreement **or by a public utility**, the court may declare that this section does not apply — or applies only to the extent declared by the court — if the applicant satisfies the court that the operation of this section would likely cause the applicant significant financial hardship.

(7) Subsection (1) does not apply

> **(*a*) in respect of an eligible financial contract; or**
> **(*b*) to prevent a member of the Canadian Payments Association from ceasing to act as a clearing agent or group clearer for a company in accordance with the *Canadian Payments Act* and the bylaws and rules of that Association.**

(8) The following actions are permitted in respect of an eligible financial contract that is entered into before proceedings under this Act are commenced in respect of the company and is terminated on or after that day, but only in accordance with the provisions of that contract:

> **(*a*) the netting or setting off or compensation of obligations between the company and the other parties to the eligible financial contract; and**
> **(*b*) any dealing with financial collateral including**
>
> > **(i) the sale or foreclosure or, in the Province of Quebec, the surrender of financial collateral, and**
> > **(ii) the setting off or compensation of financial collateral or the application of the proceeds or value of financial collateral.**

(9) No order may be made under this Act if the order would have the effect of staying or restraining the actions permitted under subsection (8).

(10) If net termination values determined in accordance with an eligible financial contract referred to in subsection (8) are owed by the company to another party to the eligible financial contract, that other party is deemed to be a creditor of the company with a claim against the company in respect of those net termination values.

(11) No order may be made under this Act if the order would have the effect of subordinating financial collateral.

Rationale

Chapter 47 introduced this section to the CCAA to deal with *ipso facto* clauses, which are common in commercial agreements. An *ipso facto* clause states that an insolvency or a filing under insolvency legislation by a party to the agreement is a breach of the agreement. The section is mirrored in the BIA proposals section 65.1. Parties should be entitled to rely on agreements regardless of an insolvency filing provided that they comply with all other terms of the agreement.

Subsection (1) is amended to clarify that insolvency cannot be used as a reason to terminate an agreement. This matches the provision under proposals. Chapter 47 inadvertently left out the words "or that the company is insolvent".

Subsection (2) is amended to match the exclusions set forward in subsection (1). The intention is to ensure consistent treatment regardless of the type of agreement. In addition, the words "or that the company is insolvent" are added as described above.

Subsection (3) is amended to add the words "or that the company is insolvent" as described above.

Subsection (4) is amended to implement the obligations under *An Act to implement the Convention on International Interests in Mobile Equipment and the Protocol to the Convention on International Interests in Mobile Equipment on Matters Specific to Aircraft Equipment*. Chapter 47 inadvertently omitted inclusion of this specific language in this section.

Subsection (6) is amended to add the words "or public utility" to clarify that the provision applies to those entities as well.

Subsection (7) is added to match the provision under BIA proposals. Chapter 47 inadvertently omitted this subsection.

Also, by virtue of Clauses 104(1) and 105 of *An Act to implement certain provisions of the budget tabled in Parliament on March 19, 2007*, which received Royal Assent on June 22, 2007 (Chapter 29), the definition of eligible financial contract referred to in subparagraph (7)(*a*) is now to be found in s.2 rather than in ss.11.05(3). To ensure that this Act is compatible with this change, Clause 112 (23) provides the new wording for s.34(7).

Further, Clause 112(23) also repeats the wording of new subparagraphs (8) and (9), which were added by Chapter 29, to ensure that this Act does not inadvertently repeal those new subparagraphs.

Present Law

As enacted by Chapter 47, Clause 131 and amended by Chapter 29:

34.(1) No person may terminate or amend any agreement, including a security agreement, with a debtor company, or claim an accelerated payment, or a forfeiture of the term, under any agreement, including a security agreement, with a debtor company by reason only that an order has been made under this Act in respect of the company.

(2) If the agreement referred to in subsection (1) is a lease, the lessor may not terminate or amend the lease by reason only that an order has been made under this Act in respect of the company or that the company has not paid rent in respect of any period before the filing of the initial application in respect of the company.

(3) No public utility may discontinue service to a debtor company by reason only that an order has been made under this Act in respect of the company or that the company has not paid for services rendered, or for goods provided, before the filing of the initial application in respect of the company.

(4) Nothing in this section is to be construed as

(*a*) prohibiting a person from requiring payments to be made in cash for goods, services, use of leased property or other valuable consideration provided after the date of the filing of initial application in respect of the company; or
(*b*) requiring the further advance of money or credit.

(5) Any provision in an agreement that has the effect of providing for, or permitting, anything that, in substance, is contrary to this section is of no force or effect.

(6) The court may, on application by a party to an agreement, declare that this section does not apply, or applies only to the extent declared by the court, if the applicant satisfies the court that the operation of this section would likely cause the applicant significant financial hardship.

(7) Subsection (1) does not apply

(*a*) in respect of an eligible financial contract; or
(*b*) to prevent a member of the Canadian Payments Association from ceasing to act as a clearing agent or group clearer for a company in accordance with the *Canadian Payments Act* and the bylaws and rules of that Association.

(8) The following actions are permitted in respect of an eligible financial contract that is entered into before proceedings under this Act are commenced in respect of the company and is terminated on or after that day, but only in accordance with the provisions of that contract:

(*a*) the netting or setting off or compensation of obligations between the company and the other parties to the eligible financial contract; and
(*b*) any dealing with financial collateral including

(i) the sale or foreclosure or, in the Province of Quebec, the surrender of financial collateral, and
(ii) the setting off or compensation of financial collateral or the application of the proceeds or value of financial collateral.

(9) No order may be made under this Act if the order would have the effect of staying or restraining the actions permitted under subsection (8).

(10) If net termination values determined in accordance with an eligible financial contract referred to in subsection (8) are owed by the company to another party to the eligible financial contract, that other party is deemed to be a creditor of the company with a claim against the company in respect of those net termination values.

(11) No order may be made under this Act if the order would have the effect of subordinating financial collateral.

Bill Clause No. 78
Section No. CCAA s.36.1
Topic: *Bankruptcy and Insolvency Act* Provisions

Proposed Wording

36.1(1) Sections 38 and 95 to 101 of the *Bankruptcy and Insolvency Act* apply, with any modifications that the circumstances require, in respect of a compromise or arrangement unless the compromise or arrangement provides otherwise.

(2) For the purposes of subsection (1), a reference in sections 38 and 95 to 101 of the *Bankruptcy and Insolvency Act*

(*a*) to "date of the bankruptcy" is to be read as a reference to "day on which proceedings commence under this Act";
(*b*) to "trustee" is to be read as a reference to "monitor"; and
(*c*) to "bankrupt", "insolvent person" or "debtor" is to be read as a reference to "debtor company".

Rationale

Subsection (1) is added in order to ensure that the provisions of the BIA relating to preferences and transfer at undervalue would apply in CCAA matters. The purpose is to prevent forum shopping, where the debtor would choose the CCAA because preferences and transfer at undervalue transactions could not be attacked.

Subsection (2) is added to provide clarification that the BIA terminology is to be read in the CCAA context.

Present Law

None.

Bill Clause No. 78
Section No. CCAA s.36
Topic: Sale of Assets

Proposed Wording

36.(1) A debtor company in respect of which an order has been made under this Act may not sell or **otherwise** dispose of assets outside the ordinary course of business unless authorized to do so by a court. **Despite any requirement for shareholder approval, including one under federal or provincial law, the court may authorize the sale or disposition even if shareholder approval was not obtained.**

(2) A company that applies to the court for **an** authorization **is to** give notice of the application to **the** secured creditors who are likely to be affected by the proposed sale or **disposition**.

(3) In deciding whether to grant the authorization, the court **is to** consider, among other things,

(*a*) whether the process leading to the proposed sale or **disposition** was reasonable in the circumstances;
(*b*) whether the monitor approved the process leading to the proposed sale or **disposition**;
(*c*) whether the monitor filed with the court a report stating that in **their** opinion the sale or **disposition** would be more beneficial to **the** creditors than **a** sale or **disposition** under **a bankruptcy**;
(*d*) the extent to which the creditors were consulted;
(*e*) the effects of the proposed sale or **disposition** on the creditors and other interested parties; and
(*f*) whether the consideration to be received for the assets is reasonable and fair, taking into account **their** market value.

(4) If the proposed sale or **disposition** is to a person who is related to the company, the court may, **after considering** the factors referred to in subsection (3), grant the authorization only if it is satisfied that

(*a*) good faith efforts were made to sell or **otherwise** dispose of the assets to persons who are not related to the company; and
(*b*) the consideration to be received is superior to the consideration that would be received under **any other offer made** in **accordance with the process leading to the proposed sale or disposition.**

(**5**) For the purpose of **subsection (4)**, a person who is related to the company includes

(*a*) a director or an officer of the company;
(*b*) a person who **has or has had, directly or indirectly, control in fact of** the company; and
(*c*) a person who is related to a **person described in paragraph (*a*) or (*b*).**

(**6**) The court may **authorize a sale or disposition** free and clear of any security, charge or other restriction **and**, if it **does**, it shall also order that **other assets of the company or** the proceeds **of** the sale or **disposition be** subject to a security, charge or other restriction in favour of the **creditor** whose security, **charge** or other **restriction is to be** affected by the order.

(7) The court may grant the authorization only if the court is satisfied that the company can and **will make the payments that would have been required under paragraphs 6(4)(*a*) and (5)(*a*) if the court had sanctioned the compromise or arrangement.**

Rationale

Chapter 47 intended to provide debtors with the ability to deal with their assets outside of the ordinary course of business while restructuring, subject to certain safeguards to protect the interests of creditors.

Subsection (1) is amended to clarify that the ability of the debtor company to dispose of its assets should not be restricted by a requirement that shareholder approval be obtained.

Paragraph (3)(*c*) is amended to clarify that the disposition must be more beneficial to the creditors than a disposition under a bankruptcy scenario. The language in Chapter 47 referred to a disposition under the BIA. As the BIA contains provisions relating to bankruptcies, proposals and receiverships, it would be difficult for a court to interpret with any certainty.

Paragraph (4)(*b*) is amended to address concerns that the offer that the court considers must be a legitimate offer. As such, the court is directed to judge the offer only against the consideration that would be received in other offers made in accordance with the bidding process, and not against offers never formalized.

Subsection (5) is amended to clarify that the charge may be granted over either the proceeds from the sale or disposition or, in the alternative, over other assets. Chapter 47 inadvertently limited the court by restricting it to providing a charge on the proceeds. In some circumstances, it may be beneficial to provide the court with flexibility to determine the appropriate property to charge.

Due to drafting errors in Chapter 47, the explanation of related parties was incomplete. Subsection (6) is therefore amended to correct the explanation of who is a person related to a debtor company by including those individuals that have or had direct or indirect control of the debtor company and by clarifying that it includes persons related to those described in paragraphs (*a*) and (*b*).

Subsection (7) is added to ensure that the interests of wage earners are protected, as are the interests of other creditors. By requiring the court to consider the effect of any sale on the rights of those claimants, the risk that a debtor company will engage in a liquidating plan (i.e., a restructuring run with the intention of disposing of all assets) will be removed.

Present Law

As enacted by Chapter 47, Clause 131:

36.(1) A debtor company in respect of which an order has been made under this Act may not sell or dispose of any of its assets outside the ordinary course of its business unless authorized to do so by a court.

(2) A company that applies to the court for the authorization must give notice of the application to all secured creditors who are likely to be affected by the proposed sale or disposal of the assets to which the application relates.

(3) In deciding whether to grant the authorization, the court must consider, among other things,

(*a*) whether the process leading to the proposed sale or disposal of the assets to which the application relates was reasonable in the circumstances;
(*b*) whether the monitor approved the process leading to the proposed sale or disposal of the assets;
(*c*) whether the monitor has filed with the court a report stating that in his or her opinion the sale or disposal of the assets would be more beneficial to the creditors than if the sale or disposal took place under the *Bankruptcy and Insolvency Act*;
(*d*) the extent to which the creditors were consulted in respect of the proposed sale or disposal of the assets;
(*e*) the effects of the proposed sale or disposal on the creditors and other interested parties; and

(*f*) whether the consideration to be received for the assets is reasonable and fair, taking into account the market value of the assets.

(4) In addition to taking the factors referred to in subsection (3) into account, if the proposed sale or disposal of the assets is to a person who is related to the company, the court may grant the authorization only if it is satisfied that

(*a*) good faith efforts were made to sell or dispose of the assets to persons who are not related to the company or who are neither directors or officers of the company nor individuals who control it; and
(*b*) the consideration to be received is superior to the consideration that would be received under all other offers actually received in respect of the assets.

(5) In granting an authorization for the sale or disposal of assets, the court may order that the assets may be sold or disposed of free and clear of any security, charge or other restriction, but if it so orders, it shall also order that the proceeds realized from the sale or disposal of the assets are subject to a security, charge or other restriction in favour of the creditors whose security, charges or other restrictions are affected by the order.

(6) For the purpose of this section, a person who is related to the debtor company includes a person who controls the company, a director or an officer of the company and a person who is related to a director or an officer of the company.

Bill Clause No. 79
Section No. CCAA s.39(1)
Topic: Crown Securities

Proposed Wording

39.(1) In relation to **proceedings** under this Act in respect of a debtor company, a security provided for in federal or provincial legislation for the sole or principal purpose of securing a claim of Her Majesty in right of Canada or a province or a workers' compensation body is valid in relation to claims against the company only if, before the **day on which proceedings commence**, the security is registered under **a** system of registration of securities that is available not only to Her Majesty in right of Canada or a province or a workers' compensation body, but also to any other creditor who holds a security, and that is open to the public for information or the making of searches.

Rationale

The section is amended to reflect a change in terminology regarding the timing of proceedings.

Present Law

As enacted by Chapter 47, Clause 131:

39.(1) In relation to a proceeding under this Act in respect of a debtor company, a security provided for in federal or provincial legislation for the sole or principal purpose of securing a claim of Her Majesty in right of Canada or a province or a workers' compensation body is valid in relation to claims against the company only if the security is registered before the date of the filing of the initial application in respect of the company under any system of registration of securities that is available not only to Her Majesty in right of Canada or a province or a workers' compensation body, but also to any other creditor who holds a security, and that is open to the public for information or the making of searches.

Bill Clause No. 80
Section No. CCAA s.52(3)
Topic: Forms of Cooperation

Proposed Wording

52.(3) For the purpose of this section, cooperation may be provided by any appropriate means, including

> **(*a*) the appointment of a person to act at the direction of the court;**
> **(*b*) the communication of information by any means considered appropriate by the court;**
> **(*c*) the coordination of the administration and supervision of the debtor company's assets and affairs;**
> **(*d*) the approval or implementation by courts of agreements concerning the coordination of proceedings; and**
> **(*e*) the coordination of concurrent proceedings regarding the same debtor company.**

Rationale

Chapter 47 amended the Act by including the principles of the United Nations Commission on International Trade Law's *Model Law on Insolvency*. In cross-border insolvency situations, Canadian courts often cooperate with foreign courts. The amendment clarifies that Canadian courts should continue that practice by listing, from the *Model Law*, the forms of cooperation that courts should consider.

Present Law

None.

First · Previous · Next · Last

Date Modified: 2012-02-06

Tab 7

Case Name:

ROI Fund Inc. v. Gandi Innovations Ltd.

Between
Return On Innovation Capital Ltd. as agent for ROI Fund Inc., ROI Sceptre Canadian Retirement Fund, ROI Global Retirement Fund, and ROI High Yield Private Placement Fund and Any Other Fund Managed By ROI from time to time, Applicants, and Gandi Innovations Limited, Gandi Innovations Holdings LLC, Gandi Innovations LLC, Gandi Innovations Hold Co., and Gandi Special Holdings LLC., Respondents

[2011] O.J. No. 3827

2011 ONSC 5018

83 C.B.R. (5th) 123

2011 CarswellOnt 8590

206 A.C.W.S. (3d) 464

Court File No. 09-CL-8172

Ontario Superior Court of Justice
Commercial List

F.J.C. Newbould J.

Heard: August 18, 2011.
Judgment: August 25, 2011.

(62 paras.)

Bankruptcy and insolvency law -- Companies' Creditors Arrangement Act (CCAA) matters -- Compromises and arrangements -- Directions -- Motion by Monitor for directions allowed -- Gandi Group was under creditor protection and assets were sold with court approval -- Lender claimed repayment of debt and equity advance to Group -- Three claimants were party to advance in personal capacities -- Lender commenced arbitration proceeding against claimants -- Claimants sought indemnity of related costs from Group -- Monitor sought directions -- No evidence existed that Group entities gave indemnities or otherwise acknowledged claimants' entitlement to indemnities -- For purpose of CCAA proceedings, lender's claim and indemnity claims constituted equity claims -- Companies' Creditors Arrangement Act, s. 2(1).

Motion by the Monitor for the Gandi Group for advice and directions regarding indemnity claims made against the Group. The Gandi Group was under creditor protection. The Monitor was appointed in May 2009. The business and assets of the Group were sold with court approval. The Monitor held the proceeds for eventual distribution to unsecured creditors pursuant to a plan of compromise and arrangement. The indemnity claims arose from the 2007 reorganization of the Group's business structure. The claimants were officers and board members of Gandi

Holdings. A lender advanced $75 million by way of debt and equity to the Group. The indemnity claimants were party to the advance in their personal capacities. In 2009, the lender commenced arbitration proceedings against the claimants for the total of the advance. The claimants asserted an entitlement to indemnification by the Group in respect of any award of damages which may be made against them in the arbitration together with all legal fees incurred in defending the arbitration. The claimants' proofs of claim relied on indemnity provisions set out in the limited liability company agreement and a separate indemnification made by Gandi Holdings at the time of the lender's advance. In 2011, the Monitor disallowed the claims on the basis that any claim would be made solely against Gandi Holdings rather than against other entities in the Group.

HELD: Motion allowed. There was no evidence that any indemnities from any other Gandi Group entities were made at the time of the advance. There were no corporate records supporting the contention that two of the claimants were an officer or director of Gandi Innovations. Thus, the third claimant was the only claimant entitled to identification from Gandi Innovations pursuant to the indemnity in the company's articles. Such claim was subject to a subordination agreement in respect of the debt portion of the advance, and thus the third claimant had no right to receive payment from Gandi Innovations in respect of his claim. There was no basis for inferring that the articles of the other Group entities contained the same indemnity as contained in the articles of Gandi Innovations. There was no prior acknowledgment of liability for indemnity by the Group. The claims of both the lender and the claimants were to be treated as equity claims for the purpose of the CCAA proceeding.

Statutes, Regulations and Rules Cited:

Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, s. 2(1), s. 6(8)

Counsel:

Harvey Chaiton and Maya Poliak, for the Monitor, BDO Canada Limited.

Mathew Halpin and Evan Cobb, for TA Associates Inc.

Christopher J. Cosgriffe, for Harry Gandy, James Gandy and Trent Garmoe.

ENDORSEMENT

1 F.J.C. NEWBOULD J.:-- This is a motion brought by BDO Canada Limited in its capacity as the Court-appointed Monitor of Gandi Innovations Limited, Gandi Innovations Holdings LLC, Gandi Innovations LLC, Gandi Innovations Hold Co, and Gandi Special Holdings LLC (the "Gandi Group") for advice and directions, and particularly to determine preliminary issues in connection with the indemnity claims made by Hary Gandy, James Gandy and Trent Garmoe (the "Claimants") against all of the Gandi Group.

2 The Gandi Group is under CCAA protection. The Monitor was appointed in the Initial Order on May 8, 2009.

3 The business and assets of the Gandi Group have been sold with court approval. The proceeds from the sale are being held by the Monitor for eventual distribution to unsecured creditors pursuant to a plan of compromise and arrangement.

Arbitration proceedings and indemnity claims

4 Gandi Innovations Holdings LLC ("Gandi Holdings") was incorporated pursuant to the laws of the State of Delaware on August 24, 2007. On September 12, 2007, the Gandi Group re-organized their business structure so that Gandi Holdings became the direct or indirect parent of the other various entities comprising the Gandi Group.

5 TA Associates Inc. is a general partner for a number of TA partners. In conjunction with the reorganization of Gandi Holdings, it advanced approximately US $75 million on September 12, 2007 by way of debt and equity to the Gandi Group. The advance consisted of:

(i) an equity investment in the amount of US $50 million made pursuant to the terms of a

Membership Interest Purchase Agreement in respect of Gandi Holdings dated as of September 12, 2007 made between, among others, Gandi Holdings, TA Associates and the Claimants in their personal capacities; and

(ii) an unsecured loan in the amount of US $25 million which amount was guaranteed by other members of the Gandi Group.

6 In January 2009, TA Associates commenced an arbitration proceeding against the Claimants. In the arbitration TA Associates claim damages against the Claimants in an amount of US $75 million with interest, being the total amount of TA Associates' investment in the Gandi Group. The arbitration has not yet been heard on its merits.

7 On December 20, 2010, the Monitor received proofs of claim of Hary Gandy and James Gandy against the Gandi Group in the approximate amount of $76 million and a proof of claim of Trent Garmoe against the Gandi Group in an approximate amount of $88 million. The Claimants assert an entitlement to indemnification by the Gandi Group in respect of any award of damages which may be made against them in the arbitration together with all legal fees incurred by the Claimants in defending the arbitration.

8 The proofs of claim filed by the Claimants rely on indemnity provisions set out in the Amended and Restated Limited Liability Company Agreement of Gandi Holdings and a separate Indemnification Agreement made by Gandi Holdings entered into in connection with the Membership Agreement made at the time of the TA Associates investment with Gandi Holdings. Gandi Holdings is the only Gandi entity that is a party to these indemnity agreements.

9 On March 11, 2011 the Monitor disallowed the indemnity claims and advised the Claimants that based on the evidence filed in support of the indemnity claims, any indemnity claim would be solely against Gandi Holdings.

10 The Claimants have served notices of dispute and have provided to the Monitor a memorandum of articles of Association of Gandi Canada which provides an indemnity in favour of directors and officers of Gandi Canada in certain circumstances.

11 There is also an indemnity of Gandi Innovations Hold Co ("Gandi Hold Co"). At the relevant times James Gandy was the sole director of the company.

12 There has been an extensive search for corporate documents. The Monitor made inquiries of Jaffe Raitt Heuer & Weiss Inc., former corporate counsel of the Gandi Group, and learned that all of corporate governance documents of the Gandi Group, at Hary Gandy's request, had been sent to Stikeman Elliot LLP, insolvency counsel for the Gandi Group, following the CCAA filing date. Counsel for the Monitor attended at the offices of Stikeman Elliott and reviewed the corporate governance documents in its possession.

13 In addition the Monitor contacted counsel for Agfa, the purchaser of the assets of the Gandi Group, to inquire if it has in its possession copies of the Gandi Group's corporate governance records. The Monitor was advised by counsel for Agfa that Agfa was not able to find any corporate governance documents of the Gandi Group entities.

14 The Monitor also reviewed the books and records of the Gandi Group in storage. In addition, the Monitor advised the Claimants that should they wish to undertake a review of the Gandi Group's records in storage, the Claimants were invited to contact the Monitor and arrange for such review. The review was arranged and conducted by the Claimants on June 3, 2011.

15 It is a fact that there are not in existence documents that support the Claimants all being entitled to indemnities from each corporate entity in the Gaudi Group.

Issues

16 Whether the Claimants will ever be with held liable in the arbitration is not yet known. However, whether the Claimants have rights to indemnification against all of the Gandi Group or against only Gandi Holdings and Gandi Hold Co will assist the Monitor in determining whether to proceed with a consolidated plan of arrangement or file an alternative plan excluding Gandi Holdings and/or Gandi Hold Co which would enable the Monitor to make a meaningful distribution to unsecured creditors prior to the completion of the arbitration.

17 There is another preliminary issue. In the arbitration, TA Associates seeks to recover against the Claimants their equity investment of US $50 million, for which the Claimants in turn have sought indemnification from the Gandi Group. The Monitor seeks a preliminary determination as to whether these claims for indemnification relating to the claim by TA Associates for its equity investment constitute "equity claims" under the CCAA. A determination of this issue will assist the Monitor in determining the maximum amount which can be claimed by the Claimants and may facilitate an earlier distribution of funds available to unsecured creditors.

Discussion

(a) Indemnity agreements

18 An Amended and Restated Limited Liability Company Agreement of Gandi Holdings dated September 12, 2007 provides for an indemnity by Gandi Holdings in section 6.8(a) for board members and officers. There is no dispute that the Claimants were officers and board members of Gandi Holdings. It also contains in section 7.6 an indemnity for Members as follows:

> (a) Without limitation of any other provision of this Agreement executed in connection herewith, the Company agrees to defend, indemnify and hold each Member, its affiliates and their respective direct and indirect partners (including partners of partners and stockholders and members of partners), members, stockholders, directors, officers, employees and agents and each person who controls any of them...

19 Superwide Limited Partnership is a Member and the Claimants are partners of Superwide. Thus the Claimants are indemnified by Gandi Holdings by that provision as well.

20 There is a form on indemnity agreement made between Gandi Holdings and indemnitees. The form in the record is an unsigned copy dated September 11, 2007. Neither the monitor nor any of the parties have been able to locate any of these agreements signed in favour of the Claimants. Hary Gandi, who swore an affidavit for the Claimants, said that a copy of this agreement was signed between Gandi Holdings and each of the Claimants on September 12, 2007. It contains the following:

> WHEREAS, the Company desires to provide Indemnitee with specific contractual assurance of Indemnitee's rights to full indemnification against litigation risks and related expenses (regardless, among other things, of any amendment to or revocation of the Company's LLC Agreement or any change in the ownership of the Company or the composition of its Board of Managers) ...
>
> ...
>
> 3. Agreement to indemnify... if Indemnitee was or is a party or is threatened to be made a party to any Proceeding by reason of Indemnitee's Corporate Status, Indemnitee shall be indemnified by the Company against all Expenses and Liabilities incurred . . . ."

21 Assuming that this form of indemnity agreement was signed by Gandi Holdings and the Claimants, they would be covered by it.

22 The Claimants contend that each of the corporate entities in the Gandi Group signed an indemnity in favour of each of them. This is based on a statement in the affidavit of Hary Gandy that Gandi Holdings and the other CCAA Respondents provided additional indemnities to him, James Gandy and Trent Garmoe dated September 12, 2007. He attached to his affidavit a form of the indemnification agreement to be signed by Gandi Holdings. No affidavit was filed from James Gandy or Trent Garmoe.

23 There is no form of indemnity agreement in existence which names an indemnifier other than Gandi Holdings.

24 The date of September 12, 2007, said to be the date that all of the entities in the Gandi Group signed indemnities in favour of each of the claimants, was the date of the investment by TA Associates in which it

purchased a membership interest in Gandi Holdings only. Representatives of TA Associates received identical indemnities from Gandi Holdings. There is no evidence that any indemnities from any of the other Gandi Group entities were made at that time. To the contrary, the Membership Interest Purchase Agreement under which TA Associates purchased its membership interest in Gandi Holdings contained as a condition to closing a requirement that Gandi Holdings sign an indemnification agreement. The indemnification was only to be given by Gandi Holdings. There was no requirement for an indemnity to be given by any other entity in the Gandi Group,.

25 I do not accept the bald statement of Hary Gandy that all of the entities in the Gandi Group gave indemnities at the time. The only indemnities that were given were by Gaudi Holdings.

(b) Memorandum and articles of Gandi Hold Co

26 In the course of its investigation, the Monitor did locate an indemnity granted by Gandi Hold Co in its Memorandum and Articles in favour of its directors and officers. Those articles contain an indemnity in the same terms as the indemnity in the Gandi Innovations Limited articles, as discussed below. As the Monitor does not seek a determination regarding indemnities given by Gandi Hold Co, I need not discuss whether one or more of the Claimants is entitled to be indemnified by these articles.

(c) Articles of Association of Gandi Innovations Limited (Gandi Canada)

27 The articles of this company contain an indemnity as follows:

> Every director or officer, former director or officer, or person who acts or acted at the Company's request, as a director or officer of the Company, a body corporate, partnership or other association of which the Company is or was a shareholder, partner, member or creditor and the heirs and legal representatives of such person, in absence of any dishonesty on the part of such persons shall be indemnified by the Company...in respect of any claim made against such person ... by reason of being or having been a director or officer of the Company. [emphasis added]

28 The corporate records sent to the Monitor by the corporate solicitors who incorporated the company name James Gandy as the president, treasurer and secretary and as the sole director. Hary Gandy stated at the outset of his affidavit filed on behalf of the claimants that he was the president and chief executive officer and chairman of the board of the companies that made up the Gandi Group. There are no corporate records that support that assertion and on his cross-examination he acknowledged he had no documents, including board resolutions, contracts or appointment letters to show that he was ever a director or officer of Gandi Innovations Limited. He said that he was directing the business of all of the entities. On his cross-examination, he said that as far as he was concerned, James Handy and Trent Garmoe were directors and officers of the company.

29 James Gandy did not file any affidavit to say that he was not the president, treasurer and secretary of the company, as shown in the corporate records. Trent Garmoe did not file any affidavit. I think it fair to draw an adverse inference that their evidence would not have been helpful to their case.

30 The affidavit of Bruce Johnston filed on behalf of TA Associates states that Hary Gandy and Trent Garmoe were not directors or officers of Gandi Innovations Limited and that a document printed from the Nova Scotia Registry of Joint Stock Companies which was included in the closing documents for TA Associates' investment showed that James Gandy was the only director and officer of Gandi Innovations Limited.

31 There has been an extensive search for corporate documents but none have been found that would support Hary Gundy or Trent Garmoe as being an officer or director of Gandi Innovations Limited.

32 It is argued that the indemnity in the articles of Gandi Innovations Limited is in favour not only of officers and directors, but also "persons who acted at the Company's request as a director or officer of the Company", and that Hary Gandy and Trent Garmoe acted as directors and officers at the Company's request. There is certainly no documentary evidence of that. Presumably the request would have had to come from James Gandy, who is the sole officer and director according to the corporate records. There is no evidence from any of the Claimants that any request was made to Hary Gandy or Trent Garmoe to act as an officer or director of Gandi Innovations Limited, which one would have expected if the assertion was to be made.

33 It is also argued that the board of managers (the Delaware concept of a board of directors) of Gandi Holdings operated the subsidiaries as if they were officers and directors of the subsidiaries. Again, there is no documentary evidence of that and no evidence from any of the Claimants to support the assertion. While Hary Gandy may have operated the business in a functional sense, that does not mean that he was acting as an officer or director of any subsidiary in the corporate sense. This is not mere semantics. TA Associates made a large investment, and one of the corporate documents provided on closing was the Nova Scotia Registry of Joint Stock Companies that showed only James Gandy as an officer and director. If all of the Claimants are entitled to be indemnified by Gandi Innovations Limited, it will impact the claim of TA Associates in the CCAA proceedings.

34 In the circumstances, I find that the only person entitled to indemnification from Gandi Innovations Limited is James Gandy.

35 However, in connection with the financing provided by TA Associates, James Gandy executed a Subordination Agreement dated as of September, 12, 2007 under which he agreed that any liability or obligations of Gandi Canada to him, present or in the future, would be deferred, postponed and subordinated in all respects to the repayment in full by Gandi Innovations of all indebtedness, liabilities and obligations owing to TA Associates in connection with the purchase by TA Associates of US $25 million in notes. Until that obligation to pay the notes in full with interest has been fulfilled, any claim by James Gandy under the indemnity from Gandi Innovations Limited is subordinated to the claim of TA Associates.

36 The debt claim of TA Associates of $46,733,145 has been accepted by the Monitor. Assuming that the purchase price on the sale of the assets to Agfa is received in full, the monitor expects a distribution to unsecured creditors of approximately 27% of the value of their claims. In such circumstances, James Gundy will have no right to receive any payment from Gandi Innovations Limited in respect of his indemnity claim.

(d) Other Gaudi Group entities

37 It was asserted by the Claimants that because the Gandi companies operated essentially as one integrated company, it should be inferred that the constating documents of the other entities in the Gandi Group contained the same indemnity as contained in the bylaws of Gandi Innovations Limited and Gandi Hold Co. I do not agree.

38 Gandi Innovations LLC is a Texas company. Its Amended and Restated Operating Agreement contains the types of things normally contained in a general bylaw of an Ontario corporation. It contains no provision for indemnities. It was argued that as no articles were obtained from Texas, it could be assumed that the articles contained an indemnity provision similar to that contained in the bylaws of Gandi Innovations Limited and Gandi Hold Co. I asked counsel to obtain whatever documentation was available in Texas, and subsequently the Monitor received from its US counsel, Vinson & Elkins LLP, a copy of articles of organization for Gandi Innovations LLC dated August 2, 2004. There is nothing in these articles dealing with indemnities. Vinson & Elkins LLP advised that these articles, together with amending articles already in the possession of the Monitor, are the only corporate governance documents on file with the State of Texas.

39 Gandi Special Holdings LLC is a Delaware corporation. The Limited Liability Company Agreement of Gandi Special Holdings LLC, like the Texas company, contains the types of things normally contained in a general bylaw of an Ontario corporation. It contains no provision for indemnities. Following the hearing, the Monitor obtained through Vinson & Elkins LLP a Delaware Certificate of Formation of Gandi Special Holdings LLC. This document contains no provision for indemnities. A certificate of the Secretary of State of Delaware confirms that there were no other relevant documents on file and this was confirmed by Vinson & Elkins LLP.

40 I find that there is no indemnity in favour of the Claimants in the corporate documentation of Gandi Innovations LLC and Gandi Special Holdings LLC.

41 It is also argued on behalf of the Claimants that the Gandi Group have acknowledged an obligation to indemnify the Claimants and it is said that this arises from a meeting of the board of Gandi Holdings. It is argued that the Gandi Group through the Monitor is thus estopped from denying an indemnity for all of the Gandi Group companies. A document said to be minutes of a meeting of the board of managers of Gandi Holdings held on March 4, 2009 is relied on. That document contains the following paragraph:

> The next item on the agenda was the indemnification of the officers. It was generally agreed

that all parties would follow the Purchase Agreement between Gandi Innovations and TA Resources dated September 12, 2007: Counsel for TA had previously expressed the opinion that indemnification was not allowed under the purchase agreement. Counsel for James Gandy, Hary Gandy and Trent Garmoe together with the Corporate Counsel, Matthew Murphy had previously expressed verbal opinions that the indemnification of the officers was permitted under the Purchase Agreement. Lydia Garay, as the only member not involved in the dispute between TA and the key holders, voted to follow the advice of Corporate Counsel, Matthew Murphy. To avoid any misunderstanding, Corporate Counsel would be requested to express that opinion in writing.

42 I do not see this paragraph in the informal minutes as assisting the Claimants. It is a meeting of the board of Gandi Holdings. It says that it was generally agreed that all parties would follow the purchase agreement between Gandi Holdings and TA resources dated September 12, 2007. That purchase agreement provides for an indemnity by only Gandi Holdings. Assuming that the minutes reflect a desire of some board members to indemnify officers of subsidiary corporations, and assuming that the Claimants thought they were officers of all of the subsidiary corporations, it is quite clear from the paragraph that there was a difference of view. The minute states that counsel for TA Associates had previously expressed the opinion that indemnification was not allowed under the purchase agreement and that counsel for the Claimants together with corporate counsel, Matthew Murphy, expressed the opposite opinion. The minute states that Lydia Garay, the only member not involved in the dispute between TA Associates and the key holders, voted to follow the advice of Corporate Counsel Terry Murphy and to avoid any misunderstanding, corporate counsel would be requested to express that opinion in writing.

43 The affidavit of Bruce Johnston on behalf of TA Associates, who attended that meeting of the board of managers of Gandi Holdings swears that the Claimants voted to place Lydia Garay, a longtime employee and officer of Gandi Holdings, on the board despite a verbal agreement that he had with the Claimants to leave that board seat vacant and to work with him to appoint an outside independent board member. He stated Ms. Garay was completely reliant on the Gandy family for her job security and compensation.

44 Mr. Johnston also states in his affidavit that the indemnification of the Claimants was discussed and that he and Mr. Taylor took the position that indemnification was not permitted. He said the Claimants took the position that indemnification was permitted, despite the language of the purchase agreement, and took the position that corporate counsel for Gandi Holdings had previously given a verbal opinion that indemnification was permitted under the purchase agreement. After hearing that, and during the meeting, Mr. Johnston sent an e-mail to Mr. Murphy who two minutes later responded that he had not advised on the question of an indemnity under the purchase agreement. Mr. Johnson states that he then read that e-mail at the meeting. I accept his evidence on this.

45 Whether or not Ms. Garay was a disinterested or proper member of the board of management of Gandi Holdings, the minute states that she voted to follow the advice of corporate counsel. At the next board meeting on May 4, 2009, Ms. Garay said that she had sought the written opinion of corporate counsel but had not received it. To date no opinion from Mr. Murphy has surfaced. On the face of those minutes from March 4, 2009, there has been no approval of any indemnities in favour of the Claimants for other corporations. I cannot find on the evidence that there was any agreement that the Claimants would be indemnified by subsidiary corporations, nor is there any evidence that any subsidiary corporation ever enacted any documentation of any kind to provide such indemnities. The opposite is the case, as has been discussed.

46 Finally, the Claimants allege that the Gandi Group has previously acknowledged their liability to indemnify the Claimants for any damage, award or legal costs incurred by the following actions:

(i) certain Gandi entities made payments of defence costs in connection with the arbitration both pre-and post the CCAA filing; and

(ii) the Monitor allegedly approved payment of post-filing defence costs.

47 Until the sale of the Gandi Group to Agfa was completed, this CCAA proceeding was a debtor in possession restructuring with the business and affairs of the Gandi Group being managed by their officers and directors, specifically Hary Gundy and Trent Garmoe. Payments of legal fees to Langley and Banack Inc., U.S. lawyers for the Gandi Group and the Claimants, were made by or on authorization of Trent Garmoe.

48 Pursuant to the terms of the Initial Order, the Monitor was required to approve all expenditures over $10,000

before payment was made. The Monitor approved payment of legal fees to counsel for the Gandi Group on the general understanding that such fees were incurred by the Gandi Group in connection with the Gandi Group's insolvency proceeding and for general corporate work for the Gandi Group.

49 I accept the statement of the Monitor that it did not knowingly approve the payment of the Claimants' defence costs in connection with the arbitration.

50 Subsequent to the completion of the sale to Agfa, the Monitor learned that a nominal amount of the legal fees approved by the Monitor was subsequently allocated to cover the costs of the arbitration. I accept the statement of the Monitor that it had no input, knowledge or control over such allocation, and had it been consulted, would have been opposed to such allocation as it did not involve any member of the Gandi Group.

51 In the circumstances there is no basis for the assertion that the Monitor is somehow estopped by reason of the payment of legal fees from denying that there are other indemnities in favour of the Claimants.

(e) Are the Claimants claims debt or equity claims?

52 This involves the application of provisions of the CCAA to the claims asserted by TA Associates in the arbitration.

53 Section 6(8) of the CCAA provides:

> 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.

54 In s. 2(1) of the CCAA, equity claims are defined as follows:

> "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);

55 This definition of equity claim came into force on September 18, 2009. Although this provision does not apply to the Gandi Group's CCAA proceedings which commenced shortly prior to the legislative amendments, courts have noted that the amendments codified existing case law relating to the treatment of equity claims in insolvency proceedings. In *Re Nelson Financial Group Ltd.*, (2010) 75 B.L.R. (4th) 302, Pepall J. stated:

> 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.

56 If the claims in the arbitration commenced by TA Associates against the Claimants are equity claims, the claims by the Claimants in the CCAA process for contribution or indemnity in respect of those claims would be equity claims. The Claimants contend that the claims in the arbitration are not equity claims.

57 The claims in the arbitration by TA Associates against the creditors include claims for various breaches of contract, fraud, rescission, or in the alternative, rescissory damages, negligent misrepresentation, breach of fiduciary duty and tortious interference with advantageous business relationships and prospective economic advantage.

58 In the arbitration TA Associates seeks to recover the investment that it made in Gandi Holdings, including the US $25 million debt secured by promissory notes and the US $50 million equity investment made by way of a membership subscription in Gandi Holdings.

59 The Claimants assert that the claim for US $50 million by TA Associates cannot be an equity claim because it is based on breaches of contract, torts and equity. I do not see that as being the deciding factor. TA Associates seeks the return of its US $50 million equity investment because of various wrongdoings alleged against the Claimants and the fact that the claim is based on these causes of action does not make it any less a claim in equity. The legal tools that are used is not the important thing. It is the fact that they are being used to recover an equity investment that is important.

60 In *Re Nelson Financial Group Lrd.*, *supra*, at Peppall J. stated that historically, the claims and rights of shareholders were not treated as provable claims and ranked after creditors of an insolvent corporation in a liquidation. She also stated:

> This treatment also has been held to encompass fraudulent misrepresentation claims advanced by a shareholder seeking to recover his investment: *Re Blue Range Resource Corp.*, [2000] A.J. No. 14. 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 *Re Stirling Homex Corp.* concluded that shareholders, including those who had allegedly been defrauded, were subordinate to the general creditors when the company was insolvent.

61 As the amendments to the CCAA incorporated the historical treatment of equity claims, in my view the claims of TA Associates in the arbitration to be compensated for the loss of its equity interest of US $50 million is to be treated as an equity claim and that the claims of the Claimants for indemnity against that claim is also to be treated as an equity claim in this CCAA proceeding.

Order

62 An order in the form of a declaration shall go in accordance with these reasons.

F.J.C. NEWBOULD J.

cp/e/qlcct/qlvxw/qlced/qlhcs

Tab 8

Indexed as:

Bell ExpressVu Limited Partnership v. Rex

Bell ExpressVu Limited Partnership, appellant;
v.
Richard Rex, Richard Rex, c.o.b. as 'Can-Am Satellites', and c.o.b. as 'Can Am Satellites' and c.o.b. as 'CanAm Satellites' and c.o.b. as 'Can Am Satellite' and c.o.b. as 'Can Am Sat' and c.o.b. as 'Can-Am Satellites Digital Media Group' and c.o.b. as 'Can-Am Digital Media Group' and c.o.b. as 'Digital Media Group', Anne Marie Halley a.k.a. Anne Marie Rex, Michael Rex a.k.a. Mike Rex, Rodney Kibler a.k.a. Rod Kibler, Lee-Anne Patterson, Michelle Lee, Jay Raymond, Jason Anthony, John Doe 1 to 20, Jane Doe 1 to 20 and any other person or persons found on the premises or identified as working at the premises at 22409 McIntosh Avenue, Maple Ridge, British Columbia, who operate or work for businesses carrying on business under the name and style of 'Can-Am Satellites', 'Can Am Satellites', 'CanAm Satellites', 'Can Am Satellite', 'Can Am Sat', 'Can-Am Satellites Digital Media Group', 'Can-Am Digital Media Group', 'Digital Media Group', or one or more of them, respondents, and
The Attorney General of Canada, the Canadian Motion Picture Distributors Association, DIRECTV, Inc., the Canadian Alliance for Freedom of Information and Ideas, and the Congres Iberoamericain du Canada, interveners.

[2002] 2 S.C.R. 559

[2002] S.C.J. No. 43

2002 SCC 42

File No.: 28227.

Supreme Court of Canada

2001: December 4 / 2002: April 26.
[page560]

Present: L'Heureux-Dubé, Iacobucci, Major, Bastarache, Binnie, Arbour and LeBel JJ.

ON APPEAL FROM THE COURT OF APPEAL FOR BRITISH COLUMBIA (68 paras.)

Communications law -- Radiocommunications -- Direct-to-home distribution of television programming -- Decoding in Canada of encrypted signals originating from foreign satellite distributor -- Whether s. 9(1)(c) of Radiocommunication Act prohibits decoding of all encrypted satellite signals, with a limited exception, or whether it bars only unauthorized decoding of signals that emanate from licensed Canadian distributors -- Radiocommunication Act, R.S.C. 1985, c. R-2, s. 9(1)(c).

Statutes -- Interpretation -- Principles -- Contextual approach -- Grammatical and ordinary sense -- "Charter values" to be used as an interpretive principle only in circumstances of genuine ambiguity.

Appeals -- Constitutional questions -- Factual record necessary for constitutional questions to be answered.

The appellant engages in the distribution of direct-to-home (DTH) television programming and encrypts its signals to control reception. The respondents sell U.S. decoding systems to Canadian customers that enable them to receive and watch U.S. DTH progamming. They also provide U.S. mailing addresses to their customers who do not have one, since the U.S. broadcasters will not knowingly authorize their signals to be decoded by persons outside the United States. The appellant, as a licensed distribution undertaking, brought an action in the British Columbia Supreme Court, pursuant to ss. 9(1)(c) and 18(1) of the Radiocommunication Act, requesting in part an injunction prohibiting the respondents from assisting resident Canadians in subscribing to and decoding U.S. DTH programming. Section 9(1)(c) enjoins the decoding of encrypted signals without the authorization of the "lawful distributor of the signal or feed". The chambers judge declined to grant the injunctive relief. A majority of the Court of Appeal held that there is no contravention of s. 9(1)(c) where a person decodes unregulated signals such as those broadcast by the U.S. DTH companies, and dismissed the appellant's appeal.

[page561]

Held: The appeal should be allowed. Section 9(1)(c) of the Act prohibits the decoding of all encrypted satellite signals, with a limited exception.

It is necessary in every case for the court charged with interpreting a provision to undertake the preferred contextual and purposive interpretive approach before determining that the words are ambiguous. This requires reading the words of the Act in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act and the intention of Parliament. It is only when genuine ambiguity arises between two or more plausible readings, each equally in accordance with the intentions of the statute, that the courts need to resort to external interpretive aids, including other principles of interpretation such as the strict construction of penal statutes and the "Charter values" presumption.

When the entire context of s. 9(1)(c) is considered, and its words are read in their grammatical and ordinary sense in harmony with the legislative framework in which the provision is found, there is no ambiguity and accordingly no need to resort to any of the subsidiary principles of statutory interpretation. Because the Radiocommunication Act does not prohibit the broadcasting of subscription programming signals (apart from s. 9(1)(e), which forbids their unauthorized retransmission within Canada) and only concerns decrypting that occurs in Canada or other locations contemplated in s. 3(3), this does not give rise to any extra-territorial exercise of authority. Parliament intended to create an absolute bar on Canadian residents' decoding encrypted programming signals. The only exception to this prohibition occurs where authorization is acquired from a distributor holding the necessary legal rights in Canada to transmit the signal and provide the required authorization. The U.S. DTH distributors in the present case are not "lawful distributors" under the Act. This interpretation of s. 9(1)(c) as an absolute prohibition with a limited exception accords well with the objectives set out in the Broadcasting Act and complements the scheme of the Copyright Act.

The constitutional questions stated in this appeal are not answered because there is no Charter record permitting this Court to address the stated questions. A party cannot rely upon an entirely new argument that would have required additional evidence to be adduced at trial. "Charter values" cannot inform the interpretation given to s. 9 (1)(c) of the Radiocommunication Act, for these [page562] values are to be used as an interpretive principle only in circumstances of genuine ambiguity. A blanket presumption of Charter consistency could sometimes frustrate true legislative intent, contrary to what is mandated by the preferred approach to statutory construction, and wrongly upset the dialogic balance among the branches of governance. Where a statute is unambiguous, courts must give effect to the clearly expressed legislative intent and avoid using the Charter to achieve a different result.

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Not followed: R. v. Love (1997), 117 Man. R. (2d) 123; R. v. Ereiser (1997), 156 Sask. R. 71; R. v. LeBlanc, [1997] N.S.J. No. 476 (QL); R. v. Thériault, [2000] R.J.Q. 2736, aff'd Sup. Ct. Drummondville, No. 405-36-000044-003, June 13, 2001; R. v. Gregory Électronique Inc., [2000] Q.J. No. 4923 (QL), aff'd [2001] Q.J. No. 4925 (QL); R. v. S.D.S. Satellite Inc., C.Q. Laval, No. 540-73-000055-980, October 31, 2000; R. v. Branton (2001), 53 O.R. (3d) 737; referred to: Canada (Attorney General) v. Mossop, [1993] 1 S.C.R. 554; R. v. Open Sky Inc., [1994] M.J. No. 734 (QL), aff'd (1995), 106 Man. R. (2d) 37, leave to appeal ref'd (1996), 110 Man. R. (2d) 153; R. v. King, [1996] N.B.J. No. 449 (QL), rev'd (1997), 187 N.B.R. (2d) 185; R. v. Knibb (1997), 198 A.R. 161, aff'd [1998] A.J. No. 628 (QL); ExpressVu Inc. v. NII Norsat International Inc., [1998] 1 F.C. 245, aff'd (1997), 222 N.R. 213; WIC Premium Television Ltd. v. General Instrument Corp. (2000), 272 A.R. 201, 2000 ABQB 628; Canada (Procureure générale) v. Pearlman, [2001] R.J.Q. 2026; Ryan v. 361779 Alberta Ltd. (1997), 208 A.R. 396; R. v. Scullion, [2001] R.J.Q. 2018; Stubart Investments Ltd. v. The Queen, [1984] 1 S.C.R. 536; Québec (Communauté urbaine) v. Corp. Notre-Dame de Bon-Secours, [1994] 3 S.C.R. 3; Rizzo & Rizzo Shoes Ltd. (Re), [1998] 1 S.C.R. 27; R. v. Gladue, [1999] 1 S.C.R. 688; R. v. Araujo, [2000] 2 S.C.R. 992, 2000 SCC 65; R. v. Sharpe, [2001] 1 S.C.R. 45, 2001 SCC 2; Chieu v. Canada (Minister of Citizenship and Immigration), [2002] 1 S.C.R. 84, 2002 SCC 3; R. v. Ulybel Enterprises Ltd., [2001] 2 S.C.R. 867, 2001 SCC 56; Stoddard v. Watson, [1993] 2 S.C.R. 1069; Pointe-Claire (City) v. Quebec (Labour Court), [1997] 1 S.C.R. 1015; Marcotte v. Deputy Attorney General for Canada, [1976] 1 S.C.R. 108; R. v. Goulis (1981), 33 O.R. (2d) 55; R. v. Hasselwander, [1993] 2 S.C.R. 398; R. v. Russell, [2001] 2 S.C.R. 804, 2001 SCC 53; Westminster Bank Ltd. v. Zang, [1966] A.C. 182; CanadianOxy Chemicals Ltd. v. Canada (Attorney General), [1999] 1 S.C.R. 743; Quebec (Attorney General) v. Carrières Ste-Thérèse Ltée, [1985] 1 S.C.R. 831; Corbiere v. Canada (Minister of Indian [page563] and Northern Affairs), [1999] 2 S.C.R. 203; Bisaillon v. Keable, [1983] 2 S.C.R. 60; Perka v. The Queen, [1984] 2 S.C.R. 232; Idziak v. Canada (Minister of Justice), [1992] 3 S.C.R. 631; R. v. Gayle (2001), 54 O.R. (3d) 36, leave to appeal to S.C.C. refused, [2002] 1 S.C.R. vii; Moysa v. Alberta (Labour Relations Board), [1989] 1 S.C.R. 1572; Danson v. Ontario (Attorney General), [1990] 2 S.C.R. 1086; Baron v. Canada, [1993] 1 S.C.R. 416; R. v. Mills, [1999] 3 S.C.R. 668; Borowski v. Canada (Attorney General), [1989] 1 S.C.R. 342; RWDSU v. Dolphin Delivery Ltd., [1986] 2 S.C.R. 573; Cloutier v. Langlois, [1990] 1 S.C.R. 158; R. v. Salituro, [1991] 3 S.C.R. 654; R. v. Golden, [2001] 3 S.C.R. 679, 2001 SCC 83; R.W.D.S.U., Local 558 v. Pepsi-Cola Canada Beverages (West) Ltd., [2002] 1 S.C.R. 156, 2002 SCC 8; Hills v. Canada (Attorney General), [1988] 1 S.C.R. 513; Slaight Communications Inc. v. Davidson, [1989] 1 S.C.R. 1038; R. v. Zundel, [1992] 2 S.C.R. 731; R. v. Nova Scotia Pharmaceutical Society, [1992] 2 S.C.R. 606; R. v. Lucas, [1998] 1 S.C.R. 439; Symes v. Canada, [1993] 4 S.C.R. 695; Willick v. Willick, [1994] 3 S.C.R. 670; Vriend v. Alberta, [1998] 1 S.C.R. 493.

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APPEAL from a judgment of the British Columbia Court of Appeal (2000), 191 D.L.R. (4th) 662, 9 W.W.R. 205, 142 B.C.A.C. 230, 233 W.A.C. 230, 79 B.C.L.R. (3d) 250, [2000] B.C.J. No. 1803 (QL), 2000 BCCA 493, dismissing an appeal from a decision of the British Columbia Supreme Court, [1999] B.C.J. No. 3092 (QL), refusing to grant an injunction. Appeal allowed.

K. William McKenzie, Eugene Meehan, Q.C., and Jessica Duncan, for the appellant.
Alan D. Gold and Maureen McGuire, for all respondents except Michelle Lee.
Graham R. Garton, Q.C., and Christopher Rupar, for the intervener the Attorney General of Canada.
Roger T. Hughes, Q.C., for the intervener the Canadian Motion Picture Distributors Association.
Christopher D. Bredt, Jeffrey D. Vallis and Davit D. Akman, for the intervener DIRECTV, Inc.
Ian W. M. Angus, for the intervener the Canadian Alliance for Freedom of Information and Ideas.
Alan Riddell, for the intervener the Congres Iberoamerican du Canada.

[Quicklaw note: Please see complete list of solicitors appended at the end of the judgment.]

The judgment of the Court was delivered by

IACOBUCCI J.:--

I. Introduction

1 This appeal involves an issue that has divided courts in our country. It concerns the proper interpretation of s. 9(1)(c) of the Radiocommunication [page565] Act, R.S.C. 1985, c. R-2 (as am. by S.C. 1991, c. 11, s. 83). In practical terms, the issue is whether s. 9(1)(c) prohibits the decoding of all encrypted satellite signals, with a limited exception, or whether it bars only the unauthorized decoding of signals that emanate from licensed Canadian distributors.

2 The respondents facilitate what is generally referred to as "grey marketing" of foreign broadcast signals. Although there is much debate -- indeed rhetoric -- about the term, it is not necessary to enter that discussion in these reasons. Rather, the central issue is the much narrower one surrounding the above statutory provision: does s. 9(1)(c) operate on these facts to prohibit the decryption of encrypted signals emanating from U.S. broadcasters? For the reasons that follow, my conclusion is that it does have this effect. Consequently, I would allow the appeal.

II. Background

3 The appellant is a limited partnership engaged in the distribution of direct-to-home ("DTH") television programming. It is one of two current providers licensed by the Canadian Radio-television and Telecommunications Commission ("CRTC") as a DTH distribution undertaking under the Broadcasting Act, S.C. 1991, c. 11. There are two similar DTH satellite television distributors in the United States, neither of which possesses a CRTC licence. The door has effectively been shut on foreign entry into the regulated Canadian broadcast market since April 1996, when the Governor in Council directed the CRTC not to issue, amend or renew broadcasting licences for non-Canadian applicants (SOR/96-192). The U.S. companies are, however, licensed by their country's Federal Communications Commission to broadcast their signals within that country. The intervener DIRECTV is the larger of these two U.S. companies.

[page566]

4 DTH broadcasting makes use of satellite technology to transmit television programming signals to viewers. All DTH broadcasters own or have access to one or more satellites located in geosynchronous orbit, in a fixed position relative to the globe. The satellites are usually separated by a few degrees of Earth longitude, occupying "slots" assigned by international convention to their various countries of affiliation. The DTH broadcasters send their signals from land-based uplink stations to the satellites, which then diffuse the signals over a broad aspect of the Earth's surface, covering an area referred to as a "footprint". The broadcasting range of the satellites is oblivious to international boundaries and often extends over the territory of multiple countries. Any person who is somewhere within the footprint and equipped with the proper reception devices (typically, a small satellite reception dish antenna, amplifier, and receiver) can receive the signal.

5 The appellant makes use of satellites owned and operated by Telesat Canada, a Canadian company. Moreover, like every other DTH broadcaster in Canada and the U.S., the appellant encrypts its signals to control reception. To decode or unscramble the appellant's signals so as to permit intelligible viewing, customers must possess an additional decoding system that is specific to the appellant: the decoding systems used by other DTH broadcasters are not cross-compatible and cannot be used to decode the appellant's signals. The operational component of the decoding system is a computerized "smart card" that bears a unique code and is remotely accessible by the appellant. Through this device, once a customer has chosen and subscribed to a programming package, and rendered the appropriate fee, the appellant can communicate to the decoder that the customer is authorized to decode its signals. The decoder is then activated and the customer receives unscrambled programming.

6 The respondent, Richard Rex, carries on business as Can-Am Satellites. The other respondents are employees of, or independent contractors working for, Can-Am Satellites. The respondents are engaged in the business of selling U.S. DTH decoding [page567] systems to Canadian customers who wish to subscribe to the services offered by the U.S. DTH broadcasters, which make use of satellites owned and operated by U.S. companies and parked in orbital slots assigned to the U.S. The footprints pertaining to the U.S. DTH broadcasters are large enough for their signals to be receivable in much of Canada, but because these broadcasters will not knowingly authorize their signals to be decoded by persons outside of the U.S., the respondents also provide U.S. mailing addresses for their customers who do not already have one. The respondents then contact the U.S. DTH broadcasters on behalf of their customers, providing the customer's name, U.S. mailing address, and credit card number. Apparently, this suffices to satisfy the U.S. DTH broadcasters that the subscriber is resident in the U.S., and they then activate the customer's smart card.

7 In the past, the respondents were providing similar services for U.S. residents, so that they could obtain authorization to decode the Canadian appellant's programming signals. The respondents were authorized sales agents for the appellant at the time, but because this constituted a breach of the terms of the agency agreement, the appellant unilaterally terminated the relationship.

8 The present appeal arises from an action brought by the appellant in the Supreme Court of British Columbia. The appellant, as a licensed distribution undertaking, commenced the action pursuant to ss. 9(1)(c) and 18(1) of the Radiocommunication Act. As part of the relief it sought, the appellant requested an injunction prohibiting the respondents from assisting resident Canadians in subscribing to and decoding U.S. DTH programming. The chambers judge hearing the matter declined to grant the injunctive relief, and directed that the trial of the matter proceed on an expedited basis. On appeal of the chambers judge's ruling, Huddart J.A. dissenting, the Court of Appeal for British Columbia dismissed the appellant's appeal.

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9 The appellant applied for leave to appeal to this Court, which was granted on April 19, 2001, with costs to the applicant in any event of the cause ([2001] 1 S.C.R. vi). The Chief Justice granted the respondents' subsequent motion to state constitutional questions on September 4, 2001.

III. Relevant Statutory Provisions

10 The Radiocommunication Act is one of the legislative pillars of Canada's broadcasting framework. It and another of the pillars, the Broadcasting Act, provide context that is of central importance to this appeal. I set out the most pertinent provisions below. I will cite other provisions throughout the course of my reasons as they become relevant.

11 Radiocommunication Act, R.S.C. 1985, c. R-2

2. In this Act,

"broadcasting" means any radiocommunication in which the transmissions are intended for direct reception by the general public;

...

"encrypted" means treated electronically or otherwise for the purpose of preventing intelligible reception;

"lawful distributor", in relation to an encrypted subscription programming signal or encrypted network feed, means a person who has the lawful right in Canada to transmit it and authorize its decoding;

...

"radiocommunication" or "radio" means any transmission, emission or reception of signs, signals, writing, images, sounds or intelligence of any nature by means of electromagnetic waves of frequencies lower than 3 000 GHz propagated in space without artificial guide;

...

"subscription programming signal" means radiocommunication that is intended for reception either directly or indirectly by the public in Canada or elsewhere on payment of a subscription fee or other charge;

[page569]

9. (1) No person shall

...

(c) decode an encrypted subscription programming signal or encrypted network feed otherwise than under and in accordance with an authorization from the lawful distributor of the signal or feed;

...

10. (1) Every person who

...

(b) without lawful excuse, manufactures, imports, distributes, leases, offers for sale, sells,

installs, modifies, operates or possesses any equipment or device, or any component thereof, under circumstances that give rise to a reasonable inference that the equipment, device or component has been used, or is or was intended to be used, for the purpose of contravening section 9,

...

is guilty of an offence punishable on summary conviction and is liable, in the case of an individual, to a fine not exceeding five thousand dollars or to imprisonment for a term not exceeding one year, or to both, or, in the case of a corporation, to a fine not exceeding twenty-five thousand dollars.

...

(2.1) Every person who contravenes paragraph 9(1)(c) or (d) is guilty of an offence punishable on summary conviction and is liable, in the case of an individual, to a fine not exceeding ten thousand dollars or to imprisonment for a term not exceeding six months, or to both, or, in the case of a corporation, to a fine not exceeding twenty-five thousand dollars.

...

(2.5) No person shall be convicted of an offence under paragraph 9(1)(c), (d) or (e) if the person exercised all due diligence to prevent the commission of the offence.

...

[page570]

18. (1) Any person who

(a) holds an interest in the content of a subscription programming signal or network feed, by virtue of copyright ownership or a licence granted by a copyright owner,

...

(c) holds a licence to carry on a broadcasting undertaking issued by the Canadian Radio-television and Telecommunications Commission under the Broadcasting Act, or

...

may, where the person has suffered loss or damage as a result of conduct that is contrary to paragraph 9(1)(c), (d) or (e) or 10(1)(b), in any court of competent jurisdiction, sue for and recover damages from the person who engaged in the conduct, or obtain such other remedy, by way of injunction, accounting or otherwise, as the court considers appropriate.

...

(6) Nothing in this section affects any right or remedy that an aggrieved person may have under the Copyright Act.

Broadcasting Act, S.C. 1991, c. 11

2. (1) In this Act,

"broadcasting" means any transmission of programs, whether or not encrypted, by radio waves or other means of telecommunication for reception by the public by means of broadcasting receiving apparatus, but does not include any such transmission of programs that is made solely for performance or display in a public place;

...

"broadcasting undertaking" includes a distribution undertaking, a programming undertaking and a network; ...

"distribution undertaking" means an undertaking for the reception of broadcasting and the retransmission thereof by radio waves or other means of telecommunication to more than one permanent or [page571] temporary residence or dwelling unit or to another such undertaking;

...

(2) For the purposes of this Act, "other means of telecommunication" means any wire, cable, radio, optical or other electromagnetic system, or any similar technical system.

(3) This Act shall be construed and applied in a manner that is consistent with the freedom of expression and journalistic, creative and programming independence enjoyed by broadcasting undertakings.

3. (1) It is hereby declared as the broadcasting policy for Canada that

(a) the Canadian broadcasting system shall be effectively owned and controlled by Canadians;
(b) the Canadian broadcasting system, operating primarily in the English and French languages and comprising public, private and community elements, makes use of radio frequencies that are public property and provides, through its programming, a public service essential to the maintenance and enhancement of national identity and cultural sovereignty;

...

(d) the Canadian broadcasting system should

(i) serve to safeguard, enrich and strengthen the cultural, political, social and economic fabric of Canada,
(ii) encourage the development of Canadian expression by providing a wide range of programming that reflects Canadian attitudes, opinions, ideas, values and artistic creativity, by displaying Canadian talent in entertainment programming and by offering information and analysis concerning Canada and other countries from a Canadian point of view,
(iii) through its programming and the employment opportunities arising out of its operations, serve the needs and interests, and reflect the circumstances [page572] and aspirations, of Canadian men, women and children, including equal rights, the linguistic duality and multicultural and multiracial nature of Canadian society and the special place of aboriginal peoples within that society, and
(iv) be readily adaptable to scientific and technological change;

...

(t) distribution undertakings

(i) should give priority to the carriage of Canadian programming services and, in particular, to the carriage of local Canadian stations,
(ii) should provide efficient delivery of programming at affordable rates, using the most effective technologies available at reasonable cost,
(iii) should, where programming services are supplied to them by broadcasting undertakings pursuant to contractual arrangements, provide reasonable terms for the carriage, packaging and retailing of those programming services, and
(iv) may, where the Commission considers it appropriate, originate programming, including local programming, on such terms as are conducive to the achievement of the objectives of the broadcasting policy set out in this subsection, and in particular provide access for underserved linguistic and cultural minority communities.

(2) It is further declared that the Canadian broadcasting system constitutes a single system and that the objectives of the broadcasting policy set out in subsection (1) can best be achieved by providing for the regulation and supervision of the Canadian broadcasting system by a single independent public authority.

Copyright Act, R.S.C. 1985, c. C-42

21. (1) Subject to subsection (2), a broadcaster has a copyright in the communication signals that it broadcasts, consisting of the sole right to do the following in relation to the communication signal or any substantial part thereof:

(a) to fix it,
(b) to reproduce any fixation of it that was made without the broadcaster's consent,

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(c) to authorize another broadcaster to retransmit it to the public simultaneously with its broadcast, and
(d) in the case of a television communication signal, to perform it in a place open to the public on payment of an entrance fee,

and to authorize any act described in paragraph (a), (b) or (d).

31. ...

(2) It is not an infringement of copyright to communicate to the public by telecommunication any literary, dramatic, musical or artistic work if

(a) the communication is a retransmission of a local or distant signal;
(b) the retransmission is lawful under the Broadcasting Act;
(c) the signal is retransmitted simultaneously and in its entirety, except as otherwise required or permitted by or under the laws of Canada; and
(d) in the case of the retransmission of a distant signal, the retransmitter has paid any royalties, and complied with any terms and conditions, fixed under this Act.

IV. Judgments Below

A. Supreme Court of British Columbia, [1999] B.C.J. No. 3092 (QL)

12 In a judgment delivered orally in chambers, Brenner J. (now C.J.B.C.S.C.) noted that there is conflicting jurisprudence on the interpretation of s. 9(1)(c). It was the chambers judge's opinion, however, that the provision is unambiguous, and that it poses no contradiction to the remainder of the Radiocommunication Act. He interpreted s. 9(1)(c) as applying only to the theft of signals from "lawful distributors" in Canada, and not applying to the "paid subscription by Canadians to signals from distributors outside Canada" (para. 20). He reasoned (at paras. 18-19):

> The offence in that section that was created by the language Parliament chose to use was the offence of stealing encrypted signals from distributors in Canada. In my view, if Parliament had intended in that section to make it an offence in Canada to decode foreign encrypted [page574] transmissions originating outside Canada as contended by the [appellant], it would have said so. In s. 9(1)(c) Parliament could have used language prohibiting the unauthorized decoding of all or any subscription programming in Canada. This, it chose not to do.
>
> The interpretation of s. 9(1)(c) asserted by the [appellant] makes no distinction between those who subscribe and pay for services from non-resident distributors and those who steal the signals of lawful distributors in Canada. That interpretation would create a theft offence applicable to persons in Canada who are nonetheless paying for the services they receive. If Parliament had intended s. 9(1)(c) to apply to such conduct, it would have said so in clear language. In my view the quasi criminal provisions in the Radiocommunication Act should not be interpreted in this manner in the absence of such clear parliamentary language.

13 Brenner J. therefore refused to grant the injunctive relief sought by the appellant. He directed that the trial of the matter proceed on an expedited basis.

B. Court of Appeal for British Columbia (2000), 79 B.C.L.R. (3d) 250, 2000 BCCA 493

14 The majority of the Court of Appeal, in a judgment written by Finch J.A. (now C.J.B.C.), identified two divergent strands of case law regarding the proper interpretation of s. 9(1)(c). The majority also noted that judgments representing each side had found the provision to be unambiguous; in its assessment, though, "[l]egislation which can reasonably be said to bear two unambiguous but contradictory, interpretations must, at the very least, be said to be ambiguous" (para. 35). For this reason, and the fact that s. 9(1)(c) bears penal consequences, the majority held that the "narrower interpretation adopted by the chambers judge ... must ... prevail" (para. 35). Conflicting authorities aside, however, the majority was prepared to reach the same result through application of the principles of statutory construction.

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15 Section 9(1)(c) enjoins the decoding of encrypted signals without the authorization of the "lawful distributor of the signal or feed" (emphasis added). The majority interpreted the legislator's choice of the definite article "the", underlined in the above phrase, to mean that the prohibition applies only "to signals broadcast by lawful distributors who are licensed to authorize decoding of that signal" (para. 36). In other words, "[i]f there is no lawful distributor for an encrypted subscription program signal in Canada, there can be no one licensed to authorize its decoding" (para. 36). Consequently, according to the majority, there is no contravention of s. 9(1)(c) where a person decodes unregulated signals such as those broadcast by the U.S. DTH companies.

16 The majority characterized s. 9(1)(c) as being clearly directed at regulation of the recipient rather than the distributor, but stated that Parliament had not chosen language that would prohibit the decoding of encrypted signals regardless of origin. Rather, in the majority's view, Parliament elected to regulate merely in respect of signals transmitted by parties who are authorized by Canadian law to do so. Dismissing the appellant's argument regarding the words "or elsewhere" in the definition of "subscription programming signal", the majority held that "the fact that a subscription program signal originating outside Canada was intended for reception outside Canada, does not avoid the requirement in s. 9(1)(c) that the decoding of such signals is only unlawful if it is done without the authorization of a lawful distributor" (para. 40).

17 Basing its reasons on these considerations, the majority held that it was unnecessary to address "the wider policy issues" or the issues arising from the Canadian Charter of Rights and Freedoms (para. 44). Finding no error in the chambers judge's interpretation, the majority dismissed the appeal.

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18 Dissenting, Huddart J.A. considered the text of s. 9(1)(c) in light of the definitions set out in s. 2, and concluded that Parliamentary intent was evident: the provision "simply render[s] unlawful the decoding in Canada of all encrypted programming signals ... regardless of their source or intended destination", except where authorization is given by a person having the lawful right in Canada to transmit and authorize the decoding of the signals (para. 48). She stressed that the line of cases relied upon by the chambers judge "[a]t most ... provides support for a less inclusive interpretation of s. 9(1)(c) than its wording suggests on its face because it has penal consequences" (para. 54), and proceeded to set out a number of reasons for which these cases should not be followed.

19 For one, "the task of interpreting a statutory provision does not begin with its being typed as penal. The task of interpretation is a search for the intention of Parliament" (para. 55). As well, the more restrictive reading of s. 9 (1)(c) "ignores the broader policy objective" of the governing regulatory scheme, this being "the maintenance of a distinctively Canadian broadcasting industry in a large country with a small population within the transmission footprint of arguably the most culturally assertive country in the world with a population ten times larger" (para. 49). Huddart J.A. also referred to the existence of copyright interests, and stated that "[i]t can reasonably be inferred that U.S. distributors have commercial or legal reasons apart from Canadian laws for not seeking a Canadian market. ... Yet only Canada can control the reception of foreign signals in Canada" (para. 50).

20 Huddart J.A. declined the respondents' invitation to read s. 9(1)(c) in a manner that "respect[s] section 2(b) of the Charter" (para. 57), relying on Canada [page577] (Attorney General) v. Mossop, [1993] 1 S.C.R. 554, in this regard. She then concluded (at para. 58):

> In summary, I am not persuaded the line of cases on which the chambers judge relied establish the provision is ambiguous or capable of contradictory meanings. I do not consider courts have found two entirely different unambiguous meanings for the provision. The words of section 9(1)(c), taken alone, provide a clear basis for the determination of Parliament's intention. That meaning is consistent with the purpose of the entire regulatory scheme in the context of the international copyright agreements, with the purpose of the Act within that scheme, and with the scheme of the Act itself. Those cases interpreting the provision differently have done so with the purpose of narrowing its application to avoid penal consequences of what Parliament clearly intended to have penal consequences, as at least one of the judges taking that view explicitly acknowledged in his reasons. In my view it takes a convoluted reading of the provision to produce the result reached by the court in R. v. Love [(1997), 117 Man. R. (2d) 123 (Q.B.)], and the decisions that have followed it.

Huddart J.A. would have allowed the appeal and granted the declaration requested by the appellant.

V. Issues

21 This appeal raises three issues:

1. Does s. 9(1)(c) of the Radiocommunication Act create an absolute prohibition against decoding, followed by a limited exception, or does it allow all decoding, except for those signals for which there is a lawful distributor who has not granted its authorization?
2. Is s. 9(1)(c) of the Radiocommunication Act inconsistent with s. 2(b) of the Canadian Charter of Rights and Freedoms?
3. If the answer to the above question is "yes", can the statutory provision be justified pursuant to s. 1 of the Charter?

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VI. Analysis

A. Introduction

22 It is no exaggeration to state that s. 9(1)(c) of the federal Radiocommunication Act has received inconsistent application in the courts of this country. On one hand, there is a series of cases interpreting the provision (or suggesting that it might be interpreted) so as to create an absolute prohibition, with a limited exception where authorization from a lawful Canadian distributor is received: R. v. Open Sky Inc., [1994] M.J. No. 734 (QL) (Prov. Ct.), at para. 36, aff'd (1995), 106 Man. R. (2d) 37 (Q.B.) (sub nom. R. v. O'Connor), at para. 10, leave to appeal refused on other grounds (1996), 110 Man. R. (2d) 153 (C.A.); R. v. King, [1996] N.B.J. No. 449 (QL) (Q.B.), at paras. 19-20, rev'd on other grounds (1997), 187 N.B.R. (2d) 185 (C.A.) (sub nom. King v. Canada (Attorney General)); R. v. Knibb (1997), 198 A.R. 161 (Prov. Ct.), aff'd [1998] A.J. No. 628 (QL) (Q.B.) (sub nom. R. v. Quality Electronics (Taber) Ltd.); ExpressVu Inc. v. NII Norsat International Inc., [1998] 1 F.C. 245 (T.D.), aff'd (1997), 222 N.R. 213 (F.C.A.); WIC Premium Television Ltd. v. General Instrument Corp. (2000), 272 A.R. 201, 2000 ABQB 628, at para. 72; Canada (Procureure générale) v. Pearlman, [2001] R.J.Q. 2026 (C.Q.), at p. 2034.

23 On the other hand, there are a number of conflicting cases that have adopted the more restrictive interpretation favoured by the majority of the Court of Appeal for British Columbia in the case at bar: R. v. Love (1997), 117 Man. R. (2d) 123 (Q.B.); R. v. Ereiser (1997), 156 Sask. R. 71 (Q.B.); R. v. LeBlanc, [1997] N.S.J. No. 476 (QL) (S.C.); Ryan v. 361779 Alberta Ltd. (1997), 208 A.R. 396 (Prov. Ct.), at para. 12; R. v. Thériault, [2000] R.J.Q. 2736 (C.Q.), aff'd Sup. Ct. Drummondville, No. 405-36-000044-003, June 13, 2001 (sub nom. R. v. D'Argy); R. v. Gregory Électronique Inc., [2000] Q.J. No. 4923 (QL) (C.Q.), aff'd [2001] Q.J. No. 4925 (QL) (Sup. Ct.); R. v. S.D.S. Satellite Inc., C.Q. Laval, No. 540-73-000055-980, October 31, 2000; R. v. [page579] Scullion, [2001] R.J.Q. 2018 (C.Q.); R. v. Branton (2001), 53 O.R. (3d) 737 (C.A.).

24 As can be seen, the schism is not explained simply by the adoption of different approaches in different jurisdictions. Although the highest courts in British Columbia and Ontario have now produced decisions that bind the lower courts in those provinces to the restrictive interpretation, and although the Federal Court of Appeal has similarly bound the Trial Division courts under it to the contrary interpretation, the trial courts in Alberta, Manitoba, and Quebec have produced irreconcilable decisions. Those provinces remain without an authoritative determination on the matter. This appeal, therefore, places this Court in a position to harmonize the interpretive dissonance that is echoing throughout Canada.

25 In attempting to steer its way through this maze of cases, the Court of Appeal for British Columbia, in my respectful view, erred in its interpretation of s. 9(1)(c). In my view, there are five aspects of the majority's decision that warrant discussion. First, it commenced analysis from the belief that an ambiguity existed. Second, it placed undue emphasis on the sheer number of judges who had disagreed as to the proper interpretation of s. 9(1)(c). Third, it did not direct sufficient attention to the context of the Radiocommunication Act within the regulatory régime for broadcasting in Canada, and did not consider the objectives of that régime, feeling that it was unnecessary to address these "wider policy issues". Fourth, the majority did not read s. 9(1)(c) grammatically in accordance with its structure, namely, a prohibition with a limited exception. Finally, the majority of the court effectively inverted the words of the provision, such that the signals for which a lawful distributor could provide authorization to decode (i.e., the exception) defined the very scope of the prohibition.

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B. Does Section 9(1)(c) of the Radiocommunication Act Create an Absolute Prohibition Against Decoding, Followed by a Limited Exception, or Does it Allow all Decoding, Except for Those Signals for Which There Is a Lawful Distributor who Has not Granted its Authorization?

(1) Principles of Statutory Interpretation

26 In Elmer Driedger's definitive formulation, found at p. 87 of his Construction of Statutes (2nd ed. 1983):

> 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 Act, the object of the Act, and the intention of Parliament.

Driedger's modern approach has been repeatedly cited by this Court as the preferred approach to statutory interpretation across a wide range of interpretive settings: see, for example, Stubart Investments Ltd. v. The Queen, [1984] 1 S.C.R. 536, at p. 578, per Estey J.; Québec (Communauté urbaine) v. Corp. Notre-Dame de Bon-Secours, [1994] 3 S.C.R. 3, at p. 17; Rizzo & Rizzo Shoes Ltd. (Re), [1998] 1 S.C.R. 27, at para. 21; R. v. Gladue, [1999] 1 S.C.R. 688, at para. 25; R. v. Araujo, [2000] 2 S.C.R. 992, 2000 SCC 65, at para. 26; R. v. Sharpe, [2001] 1 S.C.R. 45, 2001 SCC 2, at para. 33, per McLachlin C.J.; Chieu v. Canada (Minister of Citizenship and Immigration), [2002] 1 S.C.R. 84, 2002 SCC 3, at para. 27. I note as well that, in the federal legislative context, this Court's preferred approach is buttressed by s. 12 of the Interpretation Act, R.S.C. 1985, c. I-21, which provides that every enactment "is deemed remedial, and shall be given such fair, large and liberal construction and interpretation as best ensures the attainment of its objects".

27 The preferred approach recognizes the important role that context must inevitably play when a court construes the written words of a statute: as Professor John Willis incisively noted in his seminal article "Statute Interpretation in a Nutshell" (1938), 16 Can. Bar Rev. 1, at p. 6, "words, like [page581] people, take their colour from their surroundings". This being the case, where the provision under consideration is found in an Act that is itself a component of a larger statutory scheme, the surroundings that colour the words and the scheme of the Act are more expansive. In such an instance, the application of Driedger's principle gives rise to what was described in R. v. Ulybel Enterprises Ltd., [2001] 2 S.C.R. 867, 2001 SCC 56, at para. 52, as "the principle of interpretation that presumes a harmony, coherence, and consistency between statutes dealing with the same subject matter". (See also Stoddard v. Watson, [1993] 2 S.C.R. 1069, at p. 1079; Pointe-Claire (City) v. Quebec (Labour Court), [1997] 1 S.C.R. 1015, at para. 61, per Lamer C.J.)

28 Other principles of interpretation -- such as the strict construction of penal statutes and the "Charter values" presumption -- only receive application where there is ambiguity as to the meaning of a provision. (On strict construction, see: Marcotte v. Deputy Attorney General for Canada, [1976] 1 S.C.R. 108, at p. 115, per Dickson J. (as he then was); R. v. Goulis (1981), 33 O.R. (2d) 55 (C.A.), at pp. 59-60; R. v. Hasselwander, [1993] 2 S.C.R. 398, at p. 413; R. v. Russell, [2001] 2 S.C.R. 804, 2001 SCC 53, at para. 46. I shall discuss the "Charter values" principle later in these reasons.)

29 What, then, in law is an ambiguity? To answer, an ambiguity must be "real" (Marcotte, supra, at p. 115). The words of the provision must be "reasonably capable of more than one meaning" (Westminster Bank Ltd. v. Zang, [1966] A.C. 182 (H.L.), at p. 222, per Lord Reid). By necessity, however, one must consider the "entire context" of a provision before one can determine if it is reasonably capable of multiple interpretations. In this regard, Major J.'s statement in CanadianOxy Chemicals Ltd. v. Canada (Attorney General), [1999] 1 S.C.R. 743, at para. 14, is apposite: "It is only when genuine ambiguity arises between two or more plausible readings, each equally in accordance with the intentions of the statute, that the courts need to resort to external interpretive aids" (emphasis added), to [page582] which I would add, "including other principles of interpretation".

30 For this reason, ambiguity cannot reside in the mere fact that several courts -- or, for that matter, several doctrinal writers -- have come to differing conclusions on the interpretation of a given provision. Just as it would be improper for one to engage in a preliminary tallying of the number of decisions supporting competing interpretations and then apply that which receives the "higher score", it is not appropriate to take as one's starting point the premise that differing interpretations reveal an ambiguity. It is necessary, in every case, for the court charged with interpreting a provision to undertake the contextual and purposive approach set out by Driedger, and thereafter to determine if "the words are ambiguous enough to induce two people to spend good money in backing two opposing views as to their meaning" (Willis, supra, at pp. 4-5).

(2) Application to this Case

31 The interpretive factors laid out by Driedger need not be canvassed separately in every case, and in any event are closely related and interdependent (Chieu, supra, at para. 28). In the context of the present appeal, I will group my discussion under two broad headings. Before commencing my analysis, however, I wish to highlight a number of issues on these facts. First, there is no dispute surrounding the fact that the signals of the U.S. DTH broadcasters are "encrypted" under the meaning of the Act, nor is there any dispute regarding the fact that the U.S. broadcasters are not "lawful distributors" under the Act. Secondly, all of the DTH broadcasters in Canada

and the U.S. require a person to pay "a subscription fee or other charge" for unscrambled reception. Finally, I note that the "encrypted network feed" portion of s. 9(1)(c) is not relevant on these facts and can be ignored for the purposes of analysis.

[page583]

(a) Grammatical and Ordinary Sense

32 In its basic form, s. 9(1)(c) is structured as a prohibition with a limited exception. Again, with the relevant portions emphasized, it states that:

> No person shall
>
> ...
>
> (c) decode an encrypted subscription programming signal or encrypted network feed otherwise than under and in accordance with an authorization from the lawful distributor of the signal or feed;
>
> Il est interdit :
>
> ...
>
> c) de décoder, sans l'autorisation de leur distributeur légitime ou en contravention avec celle-ci, un signal d'abonnement ou une alimentation réseau; [Emphasis added.]

The provision opens with the announcement of a broad prohibition ("No person shall"), follows by announcing the nature ("decode") and object ("an encrypted subscription programming signal") of the prohibition, and then announces an exception to it ("otherwise than under and in accordance with an authorization from the lawful distributor"). The French version shares the same four features, albeit in a modified order (see Provost C.Q.J. in Pearlman, supra, at p. 2031).

33 The forbidden activity is decoding. Therefore, as noted by the Court of Appeal, the prohibition in s. 9(1)(c) is directed towards the reception side of the broadcasting equation. Quite apart from the provenance of the signals at issue, where the impugned decoding occurs within Canada, there can be no issue of the statute's having an extra-territorial reach. In the present case, the reception that the appellant seeks to enjoin occurs entirely within Canada.

34 The object of the prohibition is of central importance to this appeal. What is interdicted by s. 9(1)(c) is the decoding of "an encrypted subscription programming signal" (in French, "un signal d'abonnement") (emphasis added). The usage of the indefinite article here is telling: it signifies [page584] "one, some [or] any" (Canadian Oxford Dictionary (1998), at p. 1). Thus, what is prohibited is the decoding of any encrypted subscription programming signal, subject to the ensuing exception.

35 The definition of "subscription programming signal" suggests that the prohibition extends to signals emanating from other countries. Section 2 of the Act defines that term as, "radiocommunication that is intended for reception either directly or indirectly by the public in Canada or elsewhere on payment of a subscription fee or other charge" (emphasis added). I respectfully disagree with the respondents and Weiler J.A. in Branton, supra, at para. 26, "that the wording 'or elsewhere' is limited to the type of situation contemplated in s. 3(3)" of the Act. Section 3(3) reads:

> 3. ...
>
> (3) This Act applies within Canada and on board
>
> (a) any ship, vessel or aircraft that is

(i) registered or licensed under an Act of Parliament, or
(ii) owned by, or under the direction or control of, Her Majesty in right of Canada or a province;

(b) any spacecraft that is under the direction or control of

(i) Her Majesty in right of Canada or a province,
(ii) a citizen or resident of Canada, or
(iii) a corporation incorporated or resident in Canada; and

(c) any platform, rig, structure or formation that is affixed or attached to land situated in the continental shelf of Canada.

36 This provision is directed at an entirely different issue from that which is at play in the definition of "subscription programming signal". Section 3(3) specifies the geographic scope of the Radiocommunication Act and all its constituent [page585] provisions, as is confirmed by the marginal note accompanying the subsection, which states "Geographical application". To phrase this in the context of the present appeal, any person within Canada or on board any of the things enumerated in ss. 3(3)(a) through (c) could potentially be subject to liability for unlawful decoding under s. 9(1)(c); in this way, s. 3(3) addresses the "where" question. On the other hand, the definition of "subscription programming signal" provides meaning to the s. 9(1)(c) liability by setting out the class of signals whose unauthorized decoding will trigger the provision; this addresses the object of the prohibition, or the "what" question. These are two altogether separate issues.

37 Furthermore, it was not necessary for Parliament to include the phrase "or elsewhere" in the s. 2 definition if it merely intended "subscription programming signal" to be interpreted as radiocommunication intended for direct or indirect reception by the public on board any of the s. 3(3) vessels, spacecrafts or rigs. In my view, the words "or elsewhere" were not meant to be tautological. It is sometimes stated, when a court considers the grammatical and ordinary sense of a provision, that "[t]he legislator does not speak in vain" (Quebec (Attorney General) v. Carrières Ste-Thérèse Ltée, [1985] 1 S.C.R. 831, at p. 838). Parliament has provided express direction to this effect through its enactment of s. 10 of the Interpretation Act, which states in part that "[t]he law shall be considered as always speaking". In any event, "or elsewhere" ("ou ailleurs", in French) suggests a much broader ambit than the particular and limited examples in s. 3(3), and I would be reticent to equate the two.

38 In my opinion, therefore, the definition of "subscription programming signal" encompasses signals originating from foreign distributors and intended for reception by a foreign public. Again, because the Radiocommunication Act does not prohibit the broadcasting of subscription programming signals (apart from s. 9 (1)(e), which forbids their [page586] unauthorized retransmission within Canada) and only concerns decrypting that occurs in the s. 3(3) locations, this does not give rise to any extra-territorial exercise of authority. At this stage, what this means is that, contrary to the holdings of the chambers judge and the majority of the Court of Appeal in the instant case, Parliament did in fact choose language in s. 9(1)(c) that prohibits the decoding of all encrypted subscription signals, regardless of their origin, "otherwise than under and in accordance with an authorization from the lawful distributor of the signal or feed". I shall now consider this exception.

39 The Court of Appeal relied upon the definite article found in this portion of s. 9(1)(c) ("the signal"), in order to support its narrower reading of the provision. Before this Court, counsel for the respondents submitted as well that the definite article preceding the words "lawful distributor" confirms that the provision "is only intended to operate where there is a lawful distributor". Finally, the respondents draw to our attention the French language version of the provision, and particularly the word "leur" that modifies "distributeur légitime": a number of cases considering the French version of s. 9(1)(c) have relied upon that word to arrive at the narrower interpretation (see the Court of Quebec judgments in Thériault, supra, at p. 2739; Gregory Électronique, supra, at paras. 24-26; and S.D.S. Satellite, supra, at p. 7. See also Branton, supra, at para. 25).

40 I do not agree with these opinions. The definite article "the" and the possessive adjective "leur" merely identify the party who can authorize the decoding in accordance with the exception (see Pearlman, supra, at p. 2032). Thus, while I agree with the majority of the Court of Appeal that "[i]f there is no lawful distributor for an encrypted subscription program signal in Canada, there can be no one licensed to authorize its decoding", I cannot see how it necessarily follows that decoding unregulated signals "cannot therefore be in breach of the Radiocommunication Act" (par. 36). Such an [page587] approach would require one to read words from the

exception into the prohibition, which is circular and incorrect. Again, as Provost C.Q.J. stated in Pearlman, supra, at p. 2031: [TRANSLATION] "To seek the meaning of the exception at the outset, and thereafter to define the rule by reference to the exception, is likely to distort the meaning of the text and misrepresent the intention of its author."

41 In my view, the definite articles are used in the exception portion of s. 9(1)(c) in order to identify from amongst the genus of signals captured by the prohibition (any encrypted subscription programming signal) that species of signals for which the rule is "otherwise". Grammatically, then, the choice of definite and indefinite articles essentially plays out into the following rendition: No person shall decode any (indefinite) encrypted subscription programming signal unless, for the (definite) particular signal that is decoded, the person has received authorization from the (definite) lawful distributor. Thus, as might happen, if no lawful distributor exists to grant such authorization, the general prohibition must remain in effect.

42 Although I have already stated that the U.S. DTH distributors in the present case are not "lawful distributors" under the Act, I should discuss this term, because it is important to the interpretive process. Section 2 provides that a "lawful distributor" of an encrypted subscription programming signal is "a person who has the lawful right in Canada to transmit it and authorize its decoding". In this connection, the fact that a person is authorized to transmit programming in another country does not, by that fact alone, qualify as granting the lawful right to do so in Canada. Moreover, the phrase "lawful right" ("légitimement autorisée") comprehends factors in addition to licences granted by the CRTC. In defining "lawful distributor", Parliament could have made specific reference to a person holding a CRTC licence (as it did in s. 18(1)(c)) or a Minister's licence (s. 5(1)(a)). Instead, it deliberately chose broader language. I therefore agree with the opinion [page588] of Létourneau J.A. in the Federal Court of Appeal decision in Norsat, supra, at para. 4, that

> [t]he concept of "lawful right" refers to the person who possesses the regulatory rights through proper licensing under the Act, the authorization of the Canadian Radio-television and Telecommunications Commission as well as the contractual and copyrights necessarily pertaining to the content involved in the transmission of the encrypted subscription programming signal or encrypted network feed.

As pointed out by the Attorney General of Canada, this interpretation means that even where the transmission of subscription programming signals falls outside of the definition of "broadcasting" under the Broadcasting Act (i.e., where the transmitted programming is "made solely for performance or display in a public place") and no broadcasting licence is therefore required, additional factors must still be considered before it can be determined whether the transmitter of the signals is a "lawful distributor" for the purposes of the Radiocommunication Act.

43 In the end, I conclude that when the words of s. 9(1)(c) are read in their grammatical and ordinary sense, taking into account the definitions provided in s. 2, the provision prohibits the decoding in Canada of any encrypted subscription programming signal, regardless of the signal's origin, unless authorization is received from the person holding the necessary lawful rights under Canadian law.

(b) Broader Context

44 Although the Radiocommunication Act is not, unfortunately, equipped with its own statement of purpose, it does not exist in a vacuum. The Act's focus is upon the allocation of specified radio frequencies, the authorization to possess and operate radio apparatuses, and the technical regulation of the radio spectrum. The Act also places restrictions on the reception of and interference with [page589] radiocommunication, which includes encrypted broadcast programming signals of the sort at issue. S. Handa et al., Communications Law in Canada (loose-leaf), at p. 3.8, describe the Radiocommunication Act as one "of the three statutory pillars governing carriage in Canada". These same authors note at p. 3.17 that:

> The Radiocommunication Act embraces all private and public use of the radio spectrum. The close relationship between this and the telecommunications and broadcasting Acts is determined by the fact that telecommunications and broadcasting are the two principal users of the radioelectric spectrum.

45 The Broadcasting Act came into force in 1991, in an omnibus statute that also brought substantial amendments to the Radiocommunication Act, including the addition thereto of s. 9(1)(c). Its purpose, generally, is to regulate and supervise the transmission of programming to the Canadian public. Of note for the present appeal

is that the definition of "broadcasting" in the Broadcasting Act captures the encrypted DTH programme transmissions at issue and that DTH broadcasters such as the appellant receive their licences under, and are subject to, that Act. The Broadcasting Act also enumerates 20 broad objectives of the broadcasting policy for Canada (in s. 3(1)(a) through (t)). The emphasis of the Act, however, is placed on broadcasting and not reception.

46 Ultimately, the Acts operate in tandem. On this point, I agree with the following passage from the judgment of LeGrandeur Prov. Ct. J. in Knibb, supra, at paras. 38-39, which was adopted by Gibson J. in the Federal Court, Trial Division decision in Norsat, supra, at para. 35:

> The Broadcasting Act and the Radiocommunication Act must be seen as operating together as part of a single regulatory scheme. The provisions of each statute must accordingly be read in the context of the other and [page590] consideration must be given to each statute's roll [sic] in the overall scheme. [Cite to R. Sullivan, Driedger on the Construction of Statutes (3rd ed. 1994), at p. 286.]
>
> The addition of s. 9(1)(c), (d) and (e) and other sections to the Radiocommunication Act through the provisions of the Broadcasting Act, 1991 are supportive of that approach in my view. Subsections 9(1)(c), (d) and (e) of the Radiocommunication Act must be seen as part of the mechanism by which the stated policy of regulation of broadcasting in Canada is to be fulfilled.

47 Canada's broadcasting policy has a number of distinguishing features, and evinces a decidedly cultural orientation. It declares that the radio frequencies in Canada are public property, that Canadian ownership and control of the broadcasting system should be a base premise, and that the programming offered through the broadcasting system is "a public service essential to the maintenance and enhancement of national identity and cultural sovereignty". Sections 3(1)(d) and 3(1)(t) enumerate a number of specific developmental goals for, respectively, the broadcasting system as a whole and for distribution undertakings (including DTH distribution undertakings) in particular. Finally, s. 3(2) declares that "the Canadian broadcasting system constitutes a single system" best regulated and supervised "by a single independent public authority".

48 In this context, one finds little support for the restrictive interpretation of s. 9(1)(c). Indeed, as counsel for the Attorney General of Canada argued before us, after consideration of the Canadian broadcasting policy Parliament has chosen to adopt, one may legitimately wonder

> why would Parliament enact a provision like the restrictive interpretation? Why would Parliament provide for Canadian ownership, Canadian production, Canadian content in its broadcasting and then simply leave the door open for unregulated, foreign broadcasting to come [page591] in and sweep all of that aside? What purpose would have been served?

49 On the other hand, the interpretation of s. 9(1)(c) that I have determined to result from the grammatical and ordinary sense of the provision accords well with the objectives set out in the Broadcasting Act. The fact that DTH broadcasters encrypt their signals, making it possible to concentrate regulatory efforts on the reception/decryption side of the equation, actually assists with attempts to pursue the statutory broadcasting policy objectives and to regulate and supervise the Canadian broadcasting system as a single system. It makes sense in these circumstances that Parliament would seek to encourage broadcasters to go through the regulatory process by providing that they could only grant authorization to have their signal decoded, and thereby collect their subscription fees, after regulatory approval has been granted.

50 There is another contextual factor that, while not in any way determinative, is confirmatory of the interpretation of s. 9(1)(c) as an absolute prohibition with a limited exception. As I have noted above, the concept of "lawful right" in the definition of "lawful distributor" incorporates contractual and copyright issues. According to the evidence in the present record, the commercial agreements between the appellant and its various programme suppliers require the appellant to respect the rights that these suppliers are granted by the persons holding the copyright in the programming content. The rights so acquired by the programme suppliers permit the programmes to be broadcast in specific locations, being all or part of Canada. As such, the appellant would have no lawful right to authorize decoding of its programming signals in an area not included in its geographically limited contractual right to exhibit the programming.

[page592]

51 In this way, the person holding the copyright in the programming can conclude separate licensing deals in different regions, or in different countries (e.g., Canada and the U.S.). Indeed, these arrangements appear typical of the industry: in the present appeal, the U.S. DTH broadcaster DIRECTV has advocated the same interpretation of s. 9(1)(c) as the appellant, in part because of the potential liability it faces towards both U.S. copyright holders and Canadian licencees due to the fact that its programming signals spill across the border and are being decoded in Canada.

52 I also believe that the reading of s. 9(1)(c) as an absolute prohibition with a limited exception complements the scheme of the Copyright Act. Sections 21(1)(c) and 21(1)(d) of the Copyright Act provide broadcasters with a copyright in the communication signals they transmit, granting them the sole right of retransmission (subject to the exceptions in s. 31(2)) and, in the case of a television communication signal, of performing it on payment of a fee. By reading s. 9(1)(c) as an absolute prohibition against decoding except where authorization is granted by the person with the lawful right to transmit and authorize decoding of the signal, the provision extends protection to the holders of the copyright in the programming itself, since it would proscribe the unauthorized reception of signals that violate copyright, even where no retransmission or reproduction occurs: see F. P. Eliadis and S. C. McCormack, "Vanquishing Wizards, Pirates and Musketeers: The Regulation of Encrypted Satellite TV Signals" (1993), 3 M.C.L.R. 211, at pp. 213-18. Finally, I note that the civil remedies provided for in ss. 18(1)(a) and 18(6) of the Radiocommunication Act both illustrate that copyright concerns are of relevance to the scheme of the Act, thus supporting the finding that there is a connection between these two statutes.

[page593]

(c) Section 9(1)(c) as a "Quasi-Criminal" Provision

53 I wish to comment regarding the respondents' argument regarding the penal effects that the "absolute prohibition" interpretation would bring to bear. Although the present case only arises in the context of a civil remedy the appellant is seeking under s. 18(1) of the Act (as a person who "has suffered loss or damage as a result of conduct that is contrary to paragraph 9(1)(c)") and does not therefore directly engage the penal aspects of the Radiocommunication Act, the respondents direct our attention to ss. 10(1)(b) and 10(2.1). These provisions, respectively, create summary conviction offences for every person providing equipment for the purposes of contravening s. 9 and for every person who in fact contravenes s. 9(1)(c). Respondents' counsel argued before us that, if s. 9(1)(c) is interpreted in the manner suggested by the appellant, "hundreds of thousands of Canadians can expect a knock on their door, because they will be in breach of the statute" and that "the effect of [the appellant's] submissions is to criminalize subscribers even if they pay every cent to which DIRECTV is entitled". The thrust of the respondents' submission is that the presence of ss. 10(1)(b) and 10(2.1) in the Radiocommunication Act provides context that is important to the interpretation of s. 9(1)(c), and that this context militates in favour of the respondents' position.

54 Section 9(1)(c) does have a "dual aspect", in so far as it gives rise to both civil and criminal penalties. I am not, however, persuaded that this plays an important role in the interpretive process here. In any event, I do not think it correct to insinuate that the decision in this appeal will have the effect of automatically branding every Canadian resident who subscribes to and pays for U.S. DTH broadcasting services as a criminal. The penal offence in s. 10(1)(b) requires that circumstances "give rise to a reasonable inference that the equipment, device or component has been used, or is or was intended to be used, for the purpose of contravening section 9" [page594] (emphasis added), and allows for a "lawful excuse" defence. Section 10(2.5) further provides that "[n]o person shall be convicted of an offence under paragraph 9(1)(c) ... if the person exercised all due diligence to prevent the commission of the offence". Since it is neither necessary nor appropriate to pursue the meaning of these provisions absent the proper factual context, I refrain from doing so.

(d) Conclusion

55 After considering the entire context of s. 9(1)(c), and after reading its words in their grammatical and ordinary sense in harmony with the legislative framework in which the provision is found, I find no ambiguity. Rather, I can conclude only that Parliament intended to create an absolute bar on Canadian residents decoding

encrypted programming signals. The only exception to this prohibition occurs where authorization is acquired from a distributor holding the necessary legal rights in Canada to transmit the signal and provide the required authorization. There is no need in this circumstance to resort to any of the subsidiary principles of statutory interpretation.

C. The Constitutional Questions

56 As I will discuss, I do not propose to answer the constitutional questions that have been stated in this appeal.

57 Rule 32 of the Rules of the Supreme Court of Canada, SOR/83-74, mandates that constitutional questions be stated in every appeal in which the constitutional validity or applicability of legislation is challenged, and sets out the procedural requirements to that end. As recognized by this Court, the purpose of Rule 32 is to ensure that the Attorney General of Canada, the attorneys general of the provinces, and the ministers of justice of the territories are alerted to constitutional challenges, in order that they may decide whether or not to [page595] intervene: Corbiere v. Canada (Minister of Indian and Northern Affairs), [1999] 2 S.C.R. 203, at para. 49, per L'Heureux-Dubé J.; see also B. A. Crane and H. S. Brown, Supreme Court of Canada Practice 2000 (1999), at p. 253. Rule 32 also serves to advise the parties and other potential interveners of the constitutional issues before the Court.

58 On the whole, the parties to an appeal are granted "wide latitude" by the Chief Justice or other judge of this Court in formulating the questions to be stated: Bisaillon v. Keable, [1983] 2 S.C.R. 60, at p. 71; Corbiere, supra, at para. 48. This wide latitude is especially appropriate in a case like the present, where the motion to state constitutional questions was brought by the respondents: generally, a respondent may advance any argument on appeal that would support the judgment below (Perka v. The Queen, [1984] 2 S.C.R. 232, at p. 240; Idziak v. Canada (Minister of Justice), [1992] 3 S.C.R. 631, at pp. 643-44, per Cory J.). Like many general rules, however, this one is subject to an exception. A respondent, like any other party, cannot rely upon an entirely new argument that would have required additional evidence to be adduced at trial: Perka, supra; Idziak, supra; R. v. Gayle (2001), 54 O.R. (3d) 36 (C.A.), at para. 69, leave to appeal refused January 24, 2002, [2002] 1 S.C.R. vii.

59 In like manner, even where constitutional questions are stated under Rule 32, it may ultimately turn out that the factual record on appeal provides an insufficient basis for their resolution. The Court is not obliged in such cases to provide answers: Bisaillon, supra; Crane and Brown, supra, at p. 254. In fact, there are compelling reasons not to: while we will not deal with abstract questions in the ordinary course, "[t]his policy ... is of particular importance in constitutional matters" (Moysa v. Alberta (Labour Relations Board), [1989] 1 S.C.R. 1572, at p. 1580; see also Danson v. Ontario (Attorney General), [1990] 2 S.C.R. 1086, at p. 1099; Baron v. Canada, [1993] 1 S.C.R. 416, at p. 452; R. v. Mills, [page596] [1999] 3 S.C.R. 668, at para. 38, per McLachlin and Iacobucci JJ.). Thus, as Sopinka J. stated for the Court in Borowski v. Canada (Attorney General), [1989] 1 S.C.R. 342, at p. 357: "The procedural requirements of Rule 32 of the Supreme Court Rules are not designed to introduce new issues but to define with precision the constitutional points in issue which emerge from the record" (emphasis added).

60 Respondents' counsel properly conceded during oral argument that there is no Charter record permitting this Court to address the stated questions. Rather, he argued that "Charter values" must inform the interpretation given to the Radiocommunication Act. This submission, inasmuch as it is presented as a stand alone proposition, must be rejected. Although I have already set out the preferred approach to statutory interpretation above, the manner in which the respondents would have this Court consider and apply the Charter warrants additional attention at this stage.

61 It has long been accepted that, where it will not upset the appropriate balance between judicial and legislative action, courts should apply and develop the rules of the common law in accordance with the values and principles enshrined in the Charter: RWDSU v. Dolphin Delivery Ltd., [1986] 2 S.C.R. 573, at p. 603, per McIntyre J.; Cloutier v. Langlois, [1990] 1 S.C.R. 158, at p. 184; R. v. Salituro, [1991] 3 S.C.R. 654, at p. 675; R. v. Golden, [2001] 3 S.C.R. 679, 2001 SCC 83, at para. 86, per Iacobucci and Arbour JJ.; R.W.D.S.U., Local 558 v. Pepsi-Cola Canada Beverages (West) Ltd., [2002] 1 S.C.R. 156, 2002 SCC 8, at paras. 18-19. One must keep in mind, of course, that the common law is the province of the judiciary: the courts are responsible for its application, and for ensuring that it continues to reflect the basic values of society. The courts do not, however, occupy the same role vis-à-vis statute law.

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62 Statutory enactments embody legislative will. They supplement, modify or supersede the common law. More pointedly, when a statute comes into play during judicial proceedings, the courts (absent any challenge on constitutional grounds) are charged with interpreting and applying it in accordance with the sovereign intent of the legislator. In this regard, although it is sometimes suggested that "it is appropriate for courts to prefer interpretations that tend to promote those [Charter] principles and values over interpretations that do not" (Sullivan, supra, at p. 325), it must be stressed that, to the extent this Court has recognized a "Charter values" interpretive principle, such principle can only receive application in circumstances of genuine ambiguity, i.e., where a statutory provision is subject to differing, but equally plausible, interpretations.

63 This Court has striven to make this point clear on many occasions: see, e.g., Hills v. Canada (Attorney General), [1988] 1 S.C.R. 513, at p. 558, per L'Heureux-Dubé J.; Slaight Communications Inc. v. Davidson, [1989] 1 S.C.R. 1038, at p. 1078, per Lamer J. (as he then was); R. v. Zundel, [1992] 2 S.C.R. 731, at p. 771, per McLachlin J. (as she then was); R. v. Nova Scotia Pharmaceutical Society, [1992] 2 S.C.R. 606, at p. 660; Mossop, supra, at pp. 581-82, per Lamer C.J.; R. v. Lucas, [1998] 1 S.C.R. 439, at para. 66, per Cory J.; Mills, supra, at paras. 22 and 56; Sharpe, supra, at para. 33.

64 These cases recognize that a blanket presumption of Charter consistency could sometimes frustrate true legislative intent, contrary to what is mandated by the preferred approach to statutory construction. Moreover, another rationale for restricting the "Charter values" rule was expressed in Symes v. Canada, [1993] 4 S.C.R. 695, at p. 752:

> [T]o consult the Charter in the absence of such ambiguity is to deprive the Charter of a more powerful purpose, namely, the determination of a statute's constitutional [page598] validity. If statutory meanings must be made congruent with the Charter even in the absence of ambiguity, then it would never be possible to apply, rather than simply consult, the values of the Charter. Furthermore, it would never be possible for the government to justify infringements as reasonable limits under s. 1 of the Charter, since the interpretive process would preclude one from finding infringements in the first place. [Emphasis in original.]

(See also Willick v. Willick, [1994] 3 S.C.R. 670, at pp. 679-80, per Sopinka J.)

65 This last point touches, fundamentally, upon the proper function of the courts within the Canadian democracy. In Vriend v. Alberta, [1998] 1 S.C.R. 493, at paras. 136-42, the Court described the relationship among the legislative, executive, and judicial branches of governance as being one of dialogue and mutual respect. As was stated, judicial review on Charter grounds brings a certain measure of vitality to the democratic process, in that it fosters both dynamic interaction and accountability amongst the various branches. "The work of the legislature is reviewed by the courts and the work of the court in its decisions can be reacted to by the legislature in the passing of new legislation (or even overarching laws under s. 33 of the Charter)" (Vriend, supra, at para. 139).

66 To reiterate what was stated in Symes, supra, and Willick, supra, if courts were to interpret all statutes such that they conformed to the Charter, this would wrongly upset the dialogic balance. Every time the principle were applied, it would pre-empt judicial review on Charter grounds, where resort to the internal checks and balances of s. 1 may be had. In this fashion, the legislatures would be largely shorn of their constitutional power to enact reasonable limits on Charter rights and freedoms, which would in turn be inflated to near absolute status. Quite literally, in order to avoid this result a legislature would somehow have to set out its justification for qualifying the Charter right expressly in the statutory text, all without the benefit of judicial discussion regarding the limitations that are permissible in a free and democratic society. Before long, courts would be asked to interpret this sort of enactment in light of Charter principles. The patent unworkability of [page599] such a scheme highlights the importance of retaining a forum for dialogue among the branches of governance. As such, where a statute is unambiguous, courts must give effect to the clearly expressed legislative intent and avoid using the Charter to achieve a different result.

67 It may well be that, when this matter returns to trial, the respondents' counsel will make an application to have s. 9(1)(c) of the Radiocommunication Act declared unconstitutional for violating the Charter. At that time, it will be necessary to consider evidence regarding whose expressive rights are engaged, whether these rights are violated by s. 9(1)(c), and, if they are, whether they are justified under s. 1.

VII. Disposition

68 In the result, I would allow the appeal with costs throughout, set aside the judgment of the Court of Appeal for British Columbia, and declare that s. 9(1)(c) of the Radiocommunication Act creates a prohibition against all decoding of encrypted programming signals, followed by an exception where authorization is received from the person holding the lawful right in Canada to transmit and authorize decoding of the signal. No answer is given to the constitutional questions stated by order of the Chief Justice.

Solicitors for the appellant: Crawford, McKenzie, McLean & Wilford, Orillia and Lang Michener, Ottawa.
Solicitors for all the respondents, except Michelle Lee: Gold & Fuerst, Toronto.

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Solicitor for the intervener the Attorney General of Canada: The Department of Justice, Ottawa.
Solicitors for the intervener the Canadian Motion Picture Distributors Association: Sim, Hughes, Ashton & McKay, Toronto.
Solicitors for the intervener DIRECTV, Inc.: Borden Ladner Gervais, Toronto.
Solicitor for the intervener the Canadian Alliance for Freedom of Information and Ideas: Ian W. M. Angus, Port Hope.
Solicitors for the intervener the Congres Iberoamerican du Canada: Soloway, Wright, Ottawa.

cp/e/qllls

Tab 9

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

Ce rapport est aussi disponible en français.
Des renseignements sur le Comité sont donnés sur le site:
www.senate-senat.ca/bancom.asp

Information regarding the Committee can be obtained through its web site:
www.senate-senat.ca/bancom.asp

DEBTORS AND CREDITORS SHARING THE BURDEN:

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

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S. 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 10

IN RE: TELEGROUP, INC.; BARODA HILL INVESTMENTS, LTD.; LEHERON CORPORATION, LTD.; KIMBLE JOHN WINTER, Appellants v. TELEGROUP, INC.

No. 00-3823

UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

281 F.3d 133; 2002 U.S. App. LEXIS 2415; Bankr. L. Rep. (CCH) P78,592; 47 Collier Bankr. Cas. 2d (MB) 1372; 39 Bankr. Ct. Dec. 30

October 11, 2001, Argued
February 15, 2002, Filed

PRIOR HISTORY: **[**1]** On Appeal From the United States District Court For the District of New Jersey. (D.C. Civ. No. 00-cv-02730). District Judge: Honorable Nicholas H. Politan.

DISPOSITION: Affirmed.

CASE SUMMARY:

PROCEDURAL POSTURE: Claimant shareholders filed proofs of claim seeking damages for the bankruptcy debtor's alleged breach of its agreement to use its best efforts to ensure that their stock was registered and freely tradable. The United States District Court for the District of New Jersey affirmed the bankruptcy court's order subordinating the shareholder's claims against the bankruptcy estate pursuant to 11 U.S.C.S. § 510(b). The shareholders appealed.

OVERVIEW: Stock purchase agreements required the debtor to use its best efforts to register its stock and ensure that the shares were freely tradable by a certain date. The debtor subsequently filed a voluntary Chapter 11 bankruptcy petition. The shareholders argued that had the debtor performed its obligation under the contract, they would have sold their shares as soon as the debtor's stock became freely tradable, thereby avoiding the losses incurred when the stock subsequently declined in value. The appellate court determined that the shareholders' claims arose from the purchase of the stock and were subordinated to the claims of general unsecured creditors. The shareholders' claims alleging fraud in the issuance fell squarely within the intended scope of 11 U.S.C.S. § 510(b). Based upon the legislative history, the appellate court rejected the shareholders' argument that the claims did not arise from the purchase or sale of the stock since it was predicated on conduct that occurred after the purchase or sale.

OUTCOME: The district court's order was affirmed.

CORE TERMS: stock, claimant, issuance, shareholder, subordinated, best efforts, register, stockholder, illegality, unsecured creditors, actionable, issuer, subordinating, investor, common stock, contractual provision, predicated, holder, breach of contract, subordination, tradeable, parity, stock purchase agreement, legislative history, promissory notes, subordinate, recovering, textual, damages arising, policies underlying

LexisNexis(R) Headnotes

Bankruptcy Law > Claims > Types > Unsecured Priority Claims > Subordination
Bankruptcy Law > Practice & Proceedings > Adversary Proceedings > General Overview
[HN1] A claim for breach of a provision in a stock purchase agreement requiring the issuer to use its best efforts

to register its stock and ensure that the stock is freely tradeable "arises from" the purchase of the stock for purposes of 11 U.S.C.S. § 510(b), and therefore must be subordinated.

Bankruptcy Law > Practice & Proceedings > Appeals > Standards of Review > De Novo Review
Civil Procedure > Appeals > Standards of Review > De Novo Review
[HN2] The appellate court reviews a pure question of law de novo.

Bankruptcy Law > Claims > Types > Unsecured Priority Claims > Subordination
Bankruptcy Law > Practice & Proceedings > Adversary Proceedings > General Overview
[HN3] See 11 U.S.C.S. § 510(b).

Governments > Legislation > Interpretation
[HN4] The first step in interpreting a statute is to determine whether the language at issue has a plain and unambiguous meaning with regard to the particular dispute in the case. The inquiry must cease if the statutory language is unambiguous and the statutory scheme is coherent and consistent.

Bankruptcy Law > Claims > Types > Unsecured Priority Claims > Subordination
Bankruptcy Law > Practice & Proceedings > Adversary Proceedings > General Overview
Securities Law > Blue Sky Laws > Offer & Sale
[HN5] In the context of 11 U.S.C.S. § 510(b), for a claim to arise from the purchase or sale of a security, there must obviously be some nexus or causal relationship between the claim and the sale of the security.

COUNSEL: J. BARRY COCOZIELLO, ESQUIRE, ROBERT J. McGUIRE, ESQUIRE (ARGUED), Podvey, Sachs, Meanor, Catenacci, Hildner & Cocoziello, Newark, NJ, Counsel for Appellants Baroda Hill Investments, Ltd., LeHeron Corporation, Ltd., and Kimble John Winter.

JAMES A. STEMPEL, ESQUIRE, JASON N. ZAKIA, ESQUIRE (ARGUED), Kirkland & Ellis, Chicago, IL, Counsel for Appellee Telegroup, Inc.

JUDGES: Before: BECKER, Chief Judge, SCIRICA and GREENBERG, Circuit Judges.

OPINION BY: BECKER

OPINION

[*135] OPINION OF THE COURT

BECKER, Chief Judge:

This bankruptcy appeal requires us to construe 11 U.S.C. § 510(b), which provides for the subordination of any claim for damages "arising from the purchase or sale" of a security of the debtor. The appeal arises out of a Chapter 11 Bankruptcy petition filed by appellee Telegroup, Inc. Appellants Baroda Hill Investments, Ltd., LeHeron Corporation, Ltd., and Kimble John Winter ("claimants" or "appellants") are shareholders of Telegroup who filed proofs of claim in the bankruptcy proceeding seeking damages for **[**2]** Telegroup's alleged breach of its agreement to use its best efforts to ensure that their stock was registered and freely tradeable. Claimants appeal from an order of the District Court affirming the Bankruptcy Court's order subordinating their claims against the bankruptcy estate pursuant to § 510(b).

Claimants argue that § 510(b) should be construed narrowly, so that only claims for actionable conduct -- typically some type of fraud or other illegality in the issuance of stock -- that occurred at the time of the purchase or sale of stock would be deemed to arise from that purchase or sale. Put differently, in claimants' submission, a claim must be predicated on illegality in the stock's issuance to be subordinated under § 510(b). Since the actionable conduct in this case (Telegroup's breach of contract) occurred after claimants' purchase of Telegroup's stock, claimants contend that the District Court erred in subordinating their claims.

Telegroup would read § 510(b) more broadly, so that claims for breach of a stock purchase agreement, which would not have arisen but for the purchase of Telegroup's stock, may arise from that purchase, even though the actionable conduct occurred **[**3]** after the transaction was completed. Telegroup further argues that

subordinating appellants' claims advances the policies underlying § 510(b) by preventing disappointed equity investors from recovering a portion of their investment in parity with bona fide creditors in a bankruptcy proceeding.

[*136] We agree with Telegroup, and hold that [HN1] a claim for breach of a provision in a stock purchase agreement requiring the issuer to use its best efforts to register its stock and ensure that the stock is freely tradeable "arises from" the purchase of the stock for purposes of § 510(b), and therefore must be subordinated. Accordingly, we will affirm.

I.

The relevant facts are undisputed, and can be succinctly summarized. Appellant LeHeron Corporation, Ltd. sold to Telegroup the assets of certain businesses that it owned in exchange for shares of Telegroup's common stock and a small amount of cash. As amended on June 5, 1998, the stock purchase agreements required Telegroup to use its best efforts to register its stock and ensure that the shares were freely tradeable by June 25, 1998. On February 10, 1999, Telegroup filed a voluntary Chapter 11 Bankruptcy petition, and on June 7, 1999, appellants **[**4]** filed proofs of claim against the bankruptcy estate alleging that Telegroup breached its agreement to use its best efforts to register its stock. Claimants sought damages on the theory that had Telegroup performed its obligation under the contract, they would have sold their shares as soon as Telegroup's stock became freely tradeable, thereby avoiding the losses incurred when Telegroup's stock subsequently declined in value.

Telegroup filed objections to these claims, asking the Bankruptcy Court to subordinate the claims pursuant to § 510(b), which provides that any claim for damages "arising from the purchase or sale" of common stock shall have the same priority in the distribution of the estate's assets as common stock. The Bankruptcy Court filed a written opinion and order subordinating appellants' claims, holding that because appellants' claims would not exist but for their purchase of Telegroup's stock, the claims arise from that purchase for purposes of § 510(b). The District Court affirmed, and claimants filed this appeal.

The District Court had jurisdiction pursuant to 28 U.S.C. § 158(a), and we have jurisdiction pursuant to 28 U.S.C. § 158(d). **[**5]** Because the District Court sat below as an appellate court, this Court conducts the same review of the Bankruptcy Court's order as did the District Court. See In re O'Brien Envtl. Energy, Inc., 188 F.3d 116, 122 (3d Cir. 1999). As the relevant facts are undisputed, this appeal presents [HN2] a pure question of law, which we review de novo. See id.

II.

A.

Section 510(b) of the Bankruptcy Code provides:

> [HN3] For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock.

In this case, the question is whether appellants' breach of contract claim is "a claim . . . for damages arising from the purchase or sale of . . . a security [of the debtor]." Id. Claimants concede that the securities **[**6]** that they purchased from Telegroup are common stock. Therefore, if **[*137]** their claims "arise from" the purchase of that stock, then under § 510(b) their claims would have the same priority as commonstock, and would be subordinated to the claims of general unsecured creditors.

The question of the scope of § 510(b) presents this Court with a matter of first impression. Those courts that have considered the issue appear divided on how broadly the phrase "arising from the purchase or sale of . . . a security" should be construed. Compare, e.g., In re Amarex, Inc., 78 B.R. 605, 610 (W.D. Okla. 1987) (holding that under § 510(b), a claim does not arise from the purchase or sale of a security if it is predicated on conduct that occurred after the security's issuance), with In re NAL Fin. Group, Inc., 237 B.R. 225 (Bankr. S.D. Fla. 1999) (holding that claims for breach of the debtor's agreement to use its best efforts to register its securities arise from the purchase of those securities, for purposes of § 510(b)).

In construing § 510(b), we begin, as we must, with the text of the statute. See Robinson v. Shell Oil Co., 519 U.S. 337, 340, 136 L. Ed. 2d 808, 117 S. Ct. 843 (1997) **[**7]** ([HN4] "[The] first step in interpreting a statute is to determine whether the language at issue has a plain and unambiguous meaning with regard to the particular dispute in the case."). The inquiry "must cease if the statutory language is unambiguous and the statutory scheme is coherent and consistent." Id. (internal quotation marks and citations omitted).

Claimants argue that their claims do not arise from the purchase or sale of Telegroup's common stock because a claim "arises from the purchase or sale of . . . a security" only if the claim alleges that the purchase or sale of the security was itself unlawful. According to claimants, a claim does not arise from the purchase or sale of a security if it is predicated on conduct that occurred after the purchase or sale. See In re Amarex, Inc., 78 B.R. 605, 610 (W.D. Okla. 1987) (holding that a claim for breach of a partnership agreement, because it is based on conduct that occurred after the issuance and sale of the partnership units, does not arise from the purchase or sale of those units); In re Angeles Corp., 177 B.R. 920, 926 (Bankr. C.D. Cal. 1995) (holding that claims for breach of fiduciary duty do not **[**8]** arise from the purchase or sale of limited partnership interests where the wrongful conduct occurred after the sale of those interests); see also In re Montgomery Ward Holding Corp., 272 B.R. 836, 2001 Bankr. LEXIS 158 at *20 (Bankr. D. Del. 2001) (holding that a claim arises from the purchase or sale of a security only if there is "an allegation of fraud in the purchase, sale or issuance of the . . . instrument"). Since the actionable conduct in this case includes Telegroup's alleged post-sale breach of contract, in claimants' submission the claim does not arise from the purchase or sale of debtor's stock, and therefore should not be subordinated under § 510(b).

Telegroup responds that claims arising from the purchase or sale of a security under § 510(b) include claims predicated on post-issuance conduct. See In re Geneva Steel Co., 260 B.R. 517 (B.A.P. 10th Cir. 2001) (holding that claims alleging that the debtor fraudulently induced the claimants to retain securities they had purchased from the debtor arise from the purchase or sale of those securities, for purposes of § 510(b)); In re Granite Partners, L.P., 208 B.R. 332, 333-34 (Bankr. S.D.N.Y. 1997) **[**9]** (holding that claims that debtor fraudulently induced claimants to retain debtor's securities arise from the purchase or sale of those securities); see also In re Lenco, Inc., 116 B.R. 141 (Bankr. E.D. Mo. 1990) (holding that claims **[*138]** for ERISA violations arose from the purchase or sale of debtor's securities).

Telegroup contends that appellants' claims "arise from" the purchase or sale of Telegroup's common stock because they allege a breach of the purchase agreement whereby claimants acquired shares of Telegroup stock, which required Telegroup to use its best efforts to register its stock. See In re NAL Fin. Group, Inc., 237 B.R. 225 (Bankr. S.D. Fla. 1999) (holding that claims for breach of debtor's agreement to use its best efforts to register its securities arise from the purchase of those securities, for purposes of § 510(b)); see also In re Betacom of Phoenix, Inc., 240 F.3d 823 (9th Cir. 2001) (holding that a claim for breach of a provision in a merger agreement arises from the purchase or sale of the debtor's securities); In re Int'l Wireless Communications Holdings, Inc., 257 B.R. 739, 746 (Bankr. D. Del. 2001) (disapproving **[**10]** Angeles and Amarex, supra, and holding that claims against the debtor for breach of a supplement to a share purchase agreement arise from the purchase or sale of those securities); In re Kaiser Group Int'l, Inc., 260 B.R. 684 (Bankr. D. Del. 2001) (holding that claims for breach of a merger agreement arise from the purchase or sale of debtor's securities). Therefore, in Telegroup's submission, the Bankruptcy Court correctly subordinated appellants' claims pursuant to § 510(b).

We conclude that the phrase "arising from" is ambiguous. [HN5] For a claim to "arise from the purchase or sale of . . . a security," there must obviously be some nexus or causal relationship between the claim and the sale of the security, but § 510(b)'s language alone provides little guidance in delineating the precise scope of the required nexus. On the one hand, it is reasonable, as a textual matter, to hold that the claims in this case do not "arise from" the purchase or sale of Telegroup's stock, since the claims are predicated on conduct that occurred after the stock was purchased. On the other hand, it is, in our view, more natural, as a textual matter, to read "arising from" as requiring some **[**11]** nexus or causal relationship between the claims and the purchase of the securities, but not as limiting the nexus to claims alleging illegality in the purchase itself. In particular, the text of § 510(b) is reasonably read to encompass the claims in this case, since the claims would not have arisen but for the purchase of Telegroup's stock and allege a breach of a provision of the stock purchase agreement.

Although we believe that Telegroup's reading of § 510(b) is the more comfortable reading of the provision as a textual matter, we acknowledge that the language "arising from" is nonetheless susceptible to claimants' construction. Because the text of § 510(b) is ambiguous as applied to the claims in this case, we turn to the provision's legislative history and the policies underlying the provision, to determine whether the claims "arise from" the purchase of Telegroup's stock, and therefore must be subordinated.

B.

Both the House Report on the 1978 Bankruptcy Revisions and the Report of the Commission on Bankruptcy Laws, whose proposed legislation was largely adopted by the 1978 enactment of the Bankruptcy Code, suggest that in enacting § 510(b), Congress was focusing on claims **[**12]** alleging fraud or other violations of securities laws in the issuance of the debtor's securities. See Report of the Committee on the Judiciary, Bankruptcy Law Revision, H.R. Rep. No. 95-595, at 194 (1977) ("A difficult policy question to be resolved in a business bankruptcy concerns the relative status of a security holder **[*139]** who seeks to rescind his purchase of securities or to sue for damages based on such a purchase: Should he be treated as a general unsecured creditor based on his tort claim for rescission, or should his claim be subordinated?"); Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 93-137, pt. 2, at 116 (1973) (commenting that the proposed provision "subordinates claims by holders of securities of a debtor corporation that are based on federal and state securities legislation, rules pursuant thereto, and similar laws").

In enacting § 510(b), Congress relied heavily on a law review article written by Professors John J. Slain and Homer Kripke, The Interface Between Securities Regulation and Bankruptcy -- Allocating the Risk of Illegal Securities Issuance Between Security holders and the Issuer's Creditors, 48 N.Y.U. L. Rev. 261 (1973). **[**13]** See H.R. Rep. No. 95-595, at 196 (summarizing the argument in the Slain/Kripke article and stating that "the bill generally adopts the Slain/Kripke position"); id. at 194 ("The argument for mandatory subordination is best described by Professors Slain and Kripke."); In re Betacom of Phoenix, Inc., 240 F.3d 823, 829 (9th Cir. 2001) ("Congress relied heavily on the analysis of two law professors in crafting the statute."); In re Granite Partners, L.P., 208 B.R. 332, 336 (Bankr. S.D.N.Y. 1997) ("Any discussion of section 510(b) must begin with the 1973 law review article authored by Professors John J. Slain and Homer Kripke . . . .").

Slain and Kripke argued that claims of shareholders alleging fraud or other illegality in the issuance of stock should generally be subordinated to the claims of general unsecured creditors, conceptualizing the issue as one of risk allocation. See generally Elizabeth Warren, Bankruptcy Policy, 54 U. Chi. L. Rev. 775, 777 (1987) ("Bankruptcy policy becomes a composite of factors that bear on a better answer to the question, 'How shall the losses be distributed?'"). Slain and Kripke argued that "the situation with which **[**14]** we are concerned involves two risks: (1) the risk of business insolvency from whatever cause; and (2) the risk of illegality in securities issuance." Slain & Kripke, supra, 48 N.Y.U. L. Rev. at 286.

Analyzing the first risk -- that of business insolvency -- Slain and Kripke observed that the absolute priority rule allocates this risk to shareholders. Under the absolute priority rule, "stockholders seeking to recover their investments cannot be paid before provable creditor claims have been satisfied in full." Id. at 261; see generally Consol. Rock Prods. Co. v. Dubois, 312 U.S. 510, 520-21, 85 L. Ed. 982, 61 S. Ct. 675 (1941) (holding that stockholders cannot participate in a plan of reorganization unless creditors' claims have been satisfied in full); Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 84 L. Ed. 110, 60 S. Ct. 1 (1939) (same); see also Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 436 n.2, 32 L. Ed. 2d 195, 92 S. Ct. 1678 (1972) (Douglas, J., dissenting) (discussing the history of the absolute priority rule).

The rationale for the absolute priority rule rests on the different risk-return packages purchased by stockholders and general **[**15]** creditors:

> In theory, the general creditor asserts a fixed dollar claim and leaves the variable profit to the stockholder; the stockholder takes the profit and provides a cushion of security for payment of the lender's fixed dollar claim. The absolute priority rule reflects the different degree to which each party assumes a risk of enterprise insolvency . . . .

[*140] Slain & Kripke, supra, 48 N.Y.U. L. Rev. at 286-87; see also Warren, supra, 54 U. Chi. L. Rev. at 792 ("An almost axiomatic principle of business law is that, because equity owners stand to gain the most when a business succeeds, they should absorb the costs of the business's collapse -- up to the full amount of their investment."). Thus, argued Slain and Kripke, the absolute priority rule allocates to stockholders the risk of business insolvency, and "no obvious reason exists for reallocating that risk." Slain & Kripke, supra, 48 N.Y.U. L. Rev. at 287.

Analyzing the second risk -- the risk of illegality in the issuance of stock -- Slain and Kripke argued that this risk, too, should be born by shareholders. "It is difficult to conceive of any reason for shifting even a small portion of the risk of illegality from the stockholder, since it is to the stockholder, and **[**16]** not to the creditor, that the stock is offered." 48 N.Y.U. L. Rev. at 288. Slain and Kripke therefore concluded that shareholder claims alleging illegality

in the issuance of stock should be subordinated to the claims of general unsecured creditors.

The focus of the Slain/Kripke article suggests that Congress considered claims alleging fraud or other illegality in the issuance of securities to be at the core of claims that "arise from the purchase or sale of . . . a security" for purposes of § 510(b). See Slain & Kripke, supra, at 267 ("For present purposes it suffices to say that when the basis of the stockholder's disaffection is either the issuer's failure to comply with registration requirements or the issuer's material misrepresentations, one or more state or federal claims may be made."). Indeed, the title of their article -- "The Interface Between Securities Regulation and Bankruptcy -- Allocating the Risk of Illegal Securities Issuance Between Security holders and the Issuer's Creditors" -- indicates that Slain and Kripke were primarily concerned with actionable conduct occurring in the issuance of the debtor's securities, as opposed to post-issuance conduct.

This focus in the legislative **[**17]** history on fraud or other illegality in the securities' issuance supports claimants' argument that their claims do not arise from the purchase or sale of Telegroup's stock because the actionable conduct (the breach of Telegroup's agreement to use its best efforts to register its stock) occurred after the sale was completed, and did not involve any fraud or violation of securities laws in the issuance itself. Although we thus agree with claimants that claims alleging illegality in the issuance of securities fall squarely within the intended scope of § 510(b), we cannot find anything in the legislative history indicating that Congress intended to limit the scope of § 510(b) to only such claims. In fact, Slain and Kripke explicitly declined to delineate the exact boundary between those shareholder claims that should be subordinated and those that should not. See Slain & Kripke, supra, at 267 ("We are only incidentally concerned with the precise predicate of a disaffected stockholder's efforts to recapture his investment from the corporation."). We therefore read the specific types of claims referred to in the legislative history as "arising from" the purchase or sale of a security as **[**18]** illustrative, not exhaustive, examples of claims that must be subordinated pursuant to § 510(b).

While the legislative history fails to define explicitly the intended scope of § 510(b), the legislative history, by adopting the Slain/Kripke argument, sheds light on the policies animating § 510(b), which provide guidance in deciding whether the claims in this case arise from the purchase of Telegroup's stock. Ultimately, the Slain and Kripke proposal that inspired § 510(b) **[*141]** appears intended to prevent disappointed shareholders from recovering the value of their investment by filing bankruptcy claims predicated on the issuer's unlawful conduct at the time of issuance, when the shareholders assumed the risk of business failure by investing in equity rather than debt instruments. See Slain & Kripke, supra, 48 N.Y.U. L. Rev. at 267 (framing the problem in terms of "a disaffected stockholder's efforts to recapture his investment from the corporation"); id. at 261 ("In these cases, a dissatisfied investor may rescind his purchase of stock or subordinated debt by proving that the transaction violated federal or state securities laws."); id. at 268 ("Investors in stock or in subordinated debentures may be **[**19]** able to bootstrap their way to parity with, or preference over, general creditors even in the absence of express contractual rights.").

Section 510(b) thus represents a Congressional judgment that, as between shareholders and general unsecured creditors, it is shareholders who should bear the risk of illegality in the issuance of stock in the event the issuer enters bankruptcy. See H.R. Doc. No. 93-137, pt. 1, at 22 (1973) (recommending "that claims by stockholders of a corporate debtor for rescission or damages, which if allowed will promote them to the status of creditors, be subordinated to the claims of the real creditors"). With these policies in mind, we now turn to the application of § 510(b) to the claims at issue in this case.

C.

1.

Claimants' reading of § 510(b) as requiring the subordination of only those claims alleging fraud or actionable conduct in the issuance not only is plausible as a textual matter, see supra Section II.A, but also has some appeal at an abstract level, as noted in the margin. [1] Nonetheless, the distinction that claimants' reading of § 510(b) draws between actionable conduct that occurred at the time of the purchase of the security and actionable **[**20]** conduct that occurred after the purchase seems to us to lack any meaningful basis as a matter of Congressional policy, and therefore provides an inadequate resolution of the ambiguity in the text of § 510(b) as applied to the claims in this **[*142]** case. As discussed above, Congress enacted § 510(b) to prevent disappointed shareholders from recovering their investment loss by using fraud and other securities claims to bootstrap their way to parity with general unsecured creditors in a bankruptcy proceeding. Nothing in this rationale would distinguish those shareholder claims predicated on post-issuance conduct from those shareholder claims predicated on conduct that occurred during the issuance itself. Cf. In re Granite Partners, L.P., 208 B.R. 332, 342 (Bankr. S.D.N.Y. 1997)

("There is no good reason to distinguish between allocating the risks of fraud in the purchase of a security and post-investment fraud that adversely affects the ability to sell (or hold) the investment; both are investment risks that the investors have assumed.").

1 Because appellants' claims are for breach of a contractual provision intended to limit their investment risk, their claims are arguably analogous to unsecured creditors' claims on promissory notes, and therefore should enjoy the same priority. In both cases, the claims are for breach of a contractual provision -- in the case of claimants suing on a promissory note, the contractual provision requires the debtor to repay the loan, and in this case, the contractual provision requires the debtor to use its best efforts to register its stock. In both cases the contractual provision limits the claimants' investment risk -- in the case of a promissory note, the contractual provision ensures that noteholders will be paid before any profits are distributed to shareholders, and in this case, the contractual provision ensures that stockholders can sell their stock if the corporation begins to fail, thereby recovering at least a portion of their investment.

Moreover, in both cases, the contractual provision limiting the investment risk is acquired in exchange for a lower rate of return -- in the case of noteholders, the promissory note provides only a fixed rate of return, and in this case, the issuer's agreement to use its best efforts to register its stock presumably increased the price claimants paid for the stock, thereby decreasing their expected return. This analogy between the claims of unsecured creditors suing on promissory notes and the claims of shareholders suing for breach of the issuer's agreement to use its best efforts to register its stock therefore suggests that appellants' claims should not be subordinated under § 510(b), and should be given the same priority as the claims of general unsecured creditors.

[21]** More important than the timing of the actionable conduct, from a policy standpoint, is the fact that the claims in this case seek to recover a portion of claimants' equity investment. In enacting § 510(b), Congress intended to prevent disaffected equity investors from recouping their investment losses in parity with general unsecured creditors in the event of bankruptcy. Since claimants in this case are equity investors seeking compensation for a decline in the value of Telegroup's stock, we believe that the policies underlying § 510(b) require resolving the textual ambiguity in favor of subordinating their claims. Put differently, because claimants retained the right to participate in corporate profits if Telegroup succeeded, we believe that § 510(b) prevents them from using their breach of contract claim to recover the value of their equity investment in parity with general unsecured creditors. Were we to rule in claimants' favor in this case, we would allow stockholders in claimants' position to retain their stock and share in the corporation's profits if the corporation succeeds, and to recover a portion of their investment in parity with creditors if the corporation fails.

[22]** Claimants argue that they never intended to retain their equity investment and share in Telegroup's profits, and submitted affidavits asserting that they intended to liquidate their shares as soon as Telegroup registered its stock and the stock became publicly tradeable. See Appellants' Brief at 26 ("The Claimants had no desire to become long-term investors in the Debtor. They accepted the shares as a cash substitute and intended immediately to sell those shares once the shares were registered.").

We have difficulty believing that if Telegroup's business prospects had suddenly improved and its profits had gone through the roof, claimants would nonetheless have liquidated their shares as soon as they became publicly tradeable. No profit-maximizing shareholder would liquidate her shares if the shareholder believed the expected return would exceed the shares' market value. Indeed, had claimants intended to liquidate their shares as soon as possible, they would have filed breach of contract claims immediately on June 25, 1998, when the contract was initially breached, rather than waiting until June 7, 1999, nearly a year later, to file their claims. Furthermore, if as claimants now contend, **[**23]** they never intended to assume any of the investment risks of equity-holders, it is unclear why they did not purchase non-equity securities with a fixed rate of return. The fact that claimants chose to invest in equity rather than debt instruments suggests that they preferred to retain the right to participate in profits, and with it, the risk of losing their investment if the business failed.

To be sure, it could be argued that this analysis does not warrant subordinating appellants' claims because the claims seek **[*143]** compensation for a risk that appellants did not assume. In particular, although claimants, as equity investors, assumed the risk of business failure, they did not assume the risk that Telegroup's stock would not be publicly tradeable, since they allocated that risk by contract to Telegroup. This objection to subordinating appellants' claims, however, proves too much, as it would apply equally to shareholders' claims for fraud in the issuance. Although shareholders do not assume risks that are fraudulently concealed from them, shareholder claims alleging fraud in the issuance nonetheless fall squarely within the intended scope of § 510(b). See supra Section II.B.

2.

A **[**24]** comparison of appellants' claims with claims for fraud or other illegality in the issuance of the debtor's securities, which appellants concede must be subordinated pursuant to § 510(b), further supports the

subordination of appellants' claims. The policy considerations underlying the Congressional judgment in § 510(b) that those who purchase the debtor's stock, rather than general unsecured creditors, should bear the risk of loss caused by illegality in the issuance of the stock, seem to us to apply equally to the claims in this case. In both cases, the claim would not exist but for claimants' purchase of debtor's stock. In both cases, the claim seeks compensation for a decline in the stock's value caused by actionable conduct on the debtor's part. And in both cases, because the stockholder, as an equity investor, assumed the risk of business failure, the stockholder must bear the risk, in the event of bankruptcy, of any unlawful conduct on the debtor's part that causes the stock's value to drop.

That the same policy considerations applicable to claims alleging fraud in the issuance of securities apply with equal force here is illustrated by considering a hypothetical case in which **[**25]** Telegroup did not contractually agree to use its best efforts to register its stock, but instead misrepresented to buyers at the time of the purchase that Telegroup was currently using its best efforts to register the stock. In such a case, the stockholders' fraud claims against Telegroup would clearly arise from the purchase of Telegroup's stock, and therefore would be subordinated pursuant to § 510(b). The only difference between that hypothetical and this case is that here, instead of fraudulently misrepresenting to buyers that it was using its best efforts to register its stock, Telegroup breached its contractual obligation to use its best efforts to register its stock.

Given that the text of § 510(b) may be reasonably read to apply to both claims alleging fraud in the issuance and the claims in this case, see supra Section II.A, we see no reason as a matter of policy why a fraud claim against Telegroup for misrepresenting to buyers that it was using its best efforts to register its stock should be subordinated under § 510(b), but a contract claim against Telegroup for breaching its agreement to use its best efforts to register its stock should not. See In re Int'l Wireless Communications Holdings, Inc., 257 B.R. 739, 746 (Bankr. D. Del. 2001) **[**26]** ("Many claims of 'defrauded' shareholders could be characterized as either [contract or tort claims]. Were we to limit the applicability of section 510(b) to tort claims, shareholders could easily avoid its effect by asserting that a debtor's fraudulent conduct in the sale of its securities was a breach of the sales contract."); In re NAL Fin. Group, Inc., 237 B.R. 225, 232 (Bankr. S.D. Fla. 1999) ("The subsequent [breach of contract] is no different than a fraud committed during the purchase for purposes of determining whether [a claim] . . . **[*144]** should be subordinated under § 510(b)."). See generally In re Betacom of Phoenix, Inc., 240 F.3d 823, 829 (9th Cir. 2001) ("There is nothing in the Slain and Kripke analysis to suggest that Congress's concern with creditor expectations and equitable risk allocation was limited to cases of debtor fraud."); In re Pub. Serv. Co. of N.H., 129 B.R. 3, 5 (Bankr. D.N.H. 1991) ("Although the claim in this case is largely based on fraud, the language of 510(b) is broad enough to include breach of contract and related actions as well.").

III.

For the foregoing reasons, we hold that a claim for a breach of **[**27]** a provision in a stock purchase agreement requiring the issuer to use its best efforts to register its stock arises from the purchase or sale of the stock, and therefore must be subordinated pursuant to § 510(b). [2] Accordingly, the order of the District Court will be affirmed.

2 Claimants argue that to subordinate their claims in this case "renders most of the language of § 510(b) superfluous," since it would mean that "any claim by an equity holder should be subordinated." Appellants' Reply Br. at 4. In particular, claimants rely on In re Angeles Corp., 177 B.R. 920 (Bankr. C.D. Cal. 1995), which stated that:

> If Congress had wanted to subordinate all claims of security holders to an equity position, regardless of the source of the claim, Congress would have worded Section 510(b) to say: "All claims made by security holders, regardless of the source of the claim, shall be subordinated to an equity class . . ." However, Bankruptcy Code Section 510(b) does not say this. Thus, Section 510(b)'s subordination of claims "arising from the sale or purchase of a security" must mean subordinating less than every claim of a security holder, regardless of how that claim arises.

Id. at 927. We agree that in enacting § 510(b), Congress did not intend to subordinate every claim brought by a shareholder, regardless of the nature of the claim. We disagree with claimants, however, that the subordination of all claims brought by shareholders is a logical consequence of our holding that claims for the breach of a stock purchase agreement requiring the issuer to use its best efforts to register its stock must be subordinated pursuant to § 510(b). Nothing in our rationale would require the subordination of a claim simply because the identity of the claimant happens to be a shareholder, where the claim lacks any causal relationship to the purchase or sale of stock and when subordinating the claims would not further the policies underlying § 510(b), which was intended to prevent shareholders from recovering their equity investment in parity with general unsecured creditors.

[28]**

Tab 11

In re: BETACOM OF PHOENIX, INC., Debtor. AMERICAN BROADCASTING SYSTEMS, INC., a Delaware Corporation; BETA COMMUNICATIONS, INC., an Arizona Corporation; BETACOM OF PHOENIX, INC., an Arizona Corporation, Plaintiffs-Appellants, v. F. PATRICK NUGENT; ANITA NUGENT, Defendants-Appellees. In re: BETACOM OF PHOENIX, INC., Debtor. AMERICAN BROADCASTING SYSTEMS, INC., a Delaware Corporation; BETA COMMUNICATIONS, INC., an Arizona Corporation; BETACOM OF PHOENIX, INC., an Arizona Corporation, Plaintiffs-Appellees, v. F. PATRICK NUGENT; ANITA NUGENT, Defendants-Appellants. In re: BETACOM OF PHOENIX, INC., dba KVVA-AM; In re: BETACOM COMMUNICATIONS, INC., dba KVVA-FM; In re: AMERICAN BROADCASTING SYSTEMS, INC. BETACOM OF PHOENIX, INC., dba KVVA-AM; BETACOM COMMUNICATIONS, INC., dba KVVA-FM; AMERICAN BROADCASTING SYSTEMS, INC., Appellants, v. SCOTT BURTON; EDWARD KNIGHT, movants, Appellees. In re: BETACOM COMMUNICATIONS, INC., dba KVVA-FM; In re: BETACOM OF PHOENIX, INC., dba KVVA-AM; In re: AMERICAN BROADCASTING SYSTEMS, INC., Debtors. EDWARD KNIGHT, movant; SCOTT BURTON, movant, Appellants-Appellees-Cross-Appellants, v. BETACOM OF PHOENIX, INC., dba KVVA-AM; BETACOM COMMUNICATIONS, INC., dba KVVA-FM; AMERICAN BROADCASTING SYSTEMS, INC., Appellees-Appellants-Cross-Appellees.

No. 98-17133, No. 98-17282, No. 98-17142, No. 98-17289

UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

240 F.3d 823; 2001 U.S. App. LEXIS 905; 37 Bankr. Ct. Dec. 86; 2001 Cal. Daily Op. Service 667; 2001 Daily Journal DAR 875

December 12, 2000, Argued and Submitted, San Francisco, California
January 24, 2001, Filed

PRIOR HISTORY: **[**1]** Appeal from the United States District Court for the District of Arizona. D.C. No. CV-97-02484-BMV. Bruce M. Van Sickle, Senior District Judge, Presiding.

Appeal from the United States District Court for the District of Arizona. D.C. No. CV-98-00813-PHX-EHC. Earl H. Caroll, District Judge, Presiding.

DISPOSITION: Bankruptcy court orders granting partial summary judgment against the Nugents and summary judgment against Knight and Burton AFFIRMED. District court orders reversing the bankruptcy court's orders granting summary judgment REVERSED. The Nugents' claims for damages relating to the two promissory notes are remanded to the bankruptcy court.

CASE SUMMARY:

PROCEDURAL POSTURE: Claimants sought parity with the general unsecured creditors of debtors. The bankruptcy court granted partial summary judgment to debtors and subordinated claimants' breach of contract claim under 11 U.S.C.S. § 510(b). The United States District Court for the District of Arizona reversed the decision to subordinate. Debtors appealed. Claimants cross-appealed the bankruptcy court's grant of partial summary judgment.

OVERVIEW: Debtor corporations filed Chapter 11 bankruptcy petitions. Claimants filed three proofs of claim in the jointly administrated cases. Two claims were for promissory notes, and the third alleged an unsecured claim

against one debtor corporation for its alleged breach of contract and fraud in connection with debtors' merger agreement. Debtors filed a complaint against claimants and two other shareholders seeking mandatory subordination of their claims. The court held that the bankruptcy court properly subordinated the claims of claimants and the other shareholders. 11 U.S.C.S. § 510(b) mandated the subordination of damages claims arising from the purchase or sale of a security. Section 510(b) was not limited to securities fraud claims. Physical possession of stock resulting from the merger was not required under § 510(b). Further, an actual sale or purchase of a security was not required to subordinate claimant's claim. It was unfair for claimants to have the same priority as creditors that extended credit following the merger. The creditors relied on claimants' shareholder contribution when they decided to extend credit.

OUTCOME: Bankruptcy court orders granting partial summary judgment against claimants was affirmed, and the district court orders reversing the bankruptcy court's orders were reversed. Claimants' breach of contract claims were properly subordinated. Claimants' claims for damages relating to promissory notes were remanded to the bankruptcy court.

CORE TERMS: stock, shareholder, merger agreement, subordinated, subordination, summary judgment, mandatory, investor, breach of contract, extend credit, promissory note, general creditors, sale of securities, claimant, securities fraud, de novo, cross-appeal, partial, merger, actual sale, subordinate, ownership, issuance, partner's, reversing, unsecured creditors, final orders, order granting, legislative history, offering

LexisNexis(R) Headnotes

Bankruptcy Law > Practice & Proceedings > Appeals > Jurisdiction
Bankruptcy Law > Practice & Proceedings > Jurisdiction > General Overview
Civil Procedure > Appeals > Appellate Jurisdiction > General Overview
[HN1] 28 U.S.C.S. § 158(d) gives a federal appeals court jurisdiction over final orders of the district court rendered in its bankruptcy appellate capacity.

Bankruptcy Law > Claims > Types > Unsecured Priority Claims > Subordination
Bankruptcy Law > Practice & Proceedings > Appeals > Jurisdiction
Civil Procedure > Summary Judgment > Partial Summary Judgments
[HN2] The decision of a bankruptcy court as to claims that were subordinated under 11 U.S.C.S. § 510(b) is a final order. Under 28 U.S.C.S. §§ 158(d) and 1291, a federal appeals court has jurisdiction over the final orders of a bankruptcy court.

Bankruptcy Law > Claims > Types > Unsecured Priority Claims > Subordination
Civil Procedure > Summary Judgment > Appellate Review > General Overview
Civil Procedure > Summary Judgment > Partial Summary Judgments
[HN3] Section 510(b) of the Bankruptcy Code mandates the subordination of damages claims arising from the purchase or sale of a security. 11 U.S.C.S. § 510(b).

Bankruptcy Law > Claims > Allowance
Bankruptcy Law > Claims > Types > Unsecured Priority Claims > Subordination
[HN4] For the purpose of a distribution under Title 11 of the United States Code, a claim arising from rescission of a purchase or sale of a security of the debtor or an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under 11 U.S.C.S. § 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock. 11 U.S.C.S. § 510(b).

Bankruptcy Law > Practice & Proceedings > Appeals > Standards of Review > Clear Error Review
Bankruptcy Law > Practice & Proceedings > Appeals > Standards of Review > De Novo Review
Civil Procedure > Appeals > Standards of Review > De Novo Review
[HN5] The appellate court reviews a district court's decision on an appeal from a bankruptcy court de novo. The bankruptcy court's grant of summary judgment is also reviewed de novo. The bankruptcy court's findings of fact are reviewed for clear error.

Bankruptcy Law > Practice & Proceedings > Appeals > Standards of Review > De Novo Review
Civil Procedure > Appeals > Standards of Review > De Novo Review

[HN6] With regard to a bankruptcy court's decision, mixed questions of law and fact are reviewed de novo.

Bankruptcy Law > Claims > Types > Unsecured Priority Claims > Subordination
Securities Law > Blue Sky Laws > Offer & Sale
[HN7] 11 U.S.C.S. § 510(b), which mandates the subordination of damages claims arising from the purchase or sale of a security, requires subordination of more than securities fraud claims.

Bankruptcy Law > Claims > Types > Unsecured Priority Claims > Subordination
[HN8] Nothing in the text of 11 U.S.C.S. § 510(b), which mandates the subordination of damages claims arising from the purchase or sale of a security, requires a subordinated claimant to be a shareholder.

Bankruptcy Law > Claims > Types > Unsecured Priority Claims > Subordination
[HN9] In determining whether or not an actual sale or purchase is required for mandatory subordination under 11 U.S.C.S. § 510(b), which mandates the subordination of damages claims arising from the purchase or sale of a security, the court must examine the reasoning behind § 510(b). There are two main rationales for mandatory subordination: (1) the dissimilar risk and return expectations of shareholders and creditors; and (2) the reliance of creditors on the equity cushion provided by shareholder investment. The first rationale applies even if there is no "actual" sale or purchase. Before they receive any stock or extend a line of credit, investors and creditors have different expectations. Even if an investor never receives her promised shares, she entered into the investment with greater financial expectations than the creditor. The creditor can only recoup her investment; the investor expects to participate in firm profits.

COUNSEL: James E. Cross, Dillingham Cross, P.L.C., Phoenix, Arizona, for the appellants.

Michael E. Gottfried, Jaburg & Wilk, P.C., Phoenix, Arizona, for appellees; Scott Burton, Scottsdale, Arizona, and Edward J. Knight, Chandler, Arizona, for the appellees/cross-appellants.

JUDGES: Before: Mary M. Schroeder, Chief Judge, Cynthia Holcomb Hall and William A. Fletcher, Circuit Judges. Opinion by Judge Hall.

OPINION BY: Cynthia Holcomb Hall

OPINION

[*826] HALL, Circuit Judge:

Appellants Patrick and Anita Nugent ("the Nugents"), claimants in the bankruptcy proceedings **[**2]** of Betacom of Phoenix, Inc., Beta Communications, Inc. (collectively, the "Betacom Entities"), and American Broadcasting Systems, Inc. ("ABS"), seek parity with the general unsecured creditors of the Betacom Entities and ABS. The bankruptcy court granted partial summary judgment to the Betacom Entities and ABS (collectively, the "Debtors") and subordinated the Nugents' breach of contract claim under 11 U.S.C. § 510(b). The district court reversed the decision of the bankruptcy court to subordinate the claim. The district court held that an actual purchase or sale of securities is necessary to trigger mandatory subordination under § 510(b) and that there was an issue of material fact as to whether there had been an actual purchase or sale of securities.

The Debtors appeal the decision of the district court. [HN1] 28 U.S.C. § 158(d) gives this Court jurisdiction over final orders of the district court rendered in its bankruptcy appellate capacity. See In re Adams Apple, Inc., 829 F.2d 1484, 1487 (9th Cir. 1987) (holding that a district court order subordinating the claims of some creditors is final).

The Nugents cross-appeal the **[**3]** bankruptcy court's grant of partial summary judgment. [HN2] The decision of the bankruptcy court is a final order as to the claims that were subordinated. See Christian Life Ctr. Litig. Defense Comm. v. Silva (In re Christian Life Ctr.), 821 F.2d 1370, 1373 (9th Cir. 1987). Under 28 U.S.C. § 158(d) and 28 U.S.C. § 1291, this Court has jurisdiction over the final orders of a bankruptcy court.

I. FACTS AND PROCEDURAL HISTORY

The Nugents were shareholders in Betacom, Inc. Betacom owned all of the outstanding stock of debtor Betacom

of Phoenix, Inc., and 80 percent of the outstanding stock of debtor Beta Communications, Inc. The Betacom Entities owned two radio stations.

In 1991, Betacom entered into a Merger Agreement with debtor ABS. The parties entered into a superseding amendment dated February 6, 1992. The Merger Agreement, as amended, provided that ABS was to acquire Betacom in exchange for ABS stock. ABS was to assume certain Betacom liabilities and agreed to use its best efforts to use the proceeds of a future registration or offering to retire the Betacom debts, including debts owed to the Nugents. The Merger Agreement called **[**4]** for an audit to determine the value of the liabilities assumed by ABS. For 45 days after the completion of the audit, the ABS shares would be held in escrow, after which they would be delivered to the Betacom shareholders. The audit was never performed, and ABS never paid the Nugents any cash or stock. In July 1992, the Nugents filed suit in federal district court against ABS and the Betacom Entities for breach of the Merger Agreement and breach of an alleged oral consultancy agreement between the Nugents and ABS (the "District Court Litigation"). In their Fourth Amended Complaint, filed on July 1, 1996, the Nugents asked for damages in lieu of the promised ABS stock. In their original and first three amended complaints, the Nugents had asked for declaratory relief in the form of a determination of the number of ABS shares to which they were entitled under the Merger Agreement as well as damages for unpaid consulting fees.

In May 1995, the Debtors filed Chapter 11 bankruptcy petitions (Nos. B95-04510, **[*827]** B95-01511, and B95-04599). The three bankruptcy cases are being jointly administered. On January 10, 1996, the Nugents filed three proofs of claim in the bankruptcy case. The first was **[**5]** an unsecured claim for $ 168,365 allegedly owed by Betacom pursuant to a promissory note dated May 1, 1989 in the principal amount of $ 68,000. The second was a secured claim for $ 693,785 pursuant to a promissory note from Betacom also dated May 1, 1989 in the principal amount of $ 159,000. The Nugents' third proof of claim alleges an unsecured, non-priority claim against ABS in the amount of $ 4,190,428 for ABS's alleged breach of contract and fraud, which was being litigated in the District Court Litigation. The Nugents obtained an order modifying the automatic stay to allow the District Court Litigation to proceed to final liquidation.

The Debtors filed a complaint in the bankruptcy court against the Nugents and two other Betacom shareholders, Scott Burton and Ed Knight, seeking mandatory subordination of their claims ("the Subordination Litigation"). [HN3] Section 510(b) of the Bankruptcy Code mandates the subordination of damages claims "arising from the purchase or sale of a security." [1] On September 30, 1997, the bankruptcy court entered the order at issue in the Nugents' cross-appeal and granted partial summary judgment in favor of the Debtors on the issue of whether the Nugents' **[**6]** claims were subordinated. A similar order was issued against Burton and Knight on April 24, 1998. The bankruptcy court reasoned that the language of the statute is "plain" and that the merger of Betacom into ABS was a "purchase or sale of securities of the Debtor." It added that a literal reading of the statute was not at odds with the statute's legislative history, which expressed a concern with adapting bankruptcy distribution to the differing expectations of shareholders and general creditors. The bankruptcy court found, however, that there was a material issue of fact whether some of the Nugents' other claims (e.g., a claim for back wages on the alleged consultation agreement with ABS) were related to the purchase or sale of securities. On these claims, the bankruptcy court denied summary judgment.

1 [HN4] For the purpose of a distribution under this title, a claim arising

> from rescission of a purchase or sale of a security of the debtor or an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock.

11 U.S.C. § 510(b).

[7]** On September 24, 1998, the district court, acting in its capacity as a bankruptcy appellate court, reversed the decision of the bankruptcy court to subordinate the Nugents' breach of contract claims. In re Betacom of Phoenix, Inc., v. American Broadcasting System, 225 B.R. 703 (D. Ariz. 1998) (the "1998 Van Sickle Order"). The district court held that: 1) an actual purchase or sale of stock is required to trigger mandatory subordination under § 510(b); and 2) when the evidence was construed in the light most favorable to the Nugents, the Debtors had not met their burden of proof in showing that there was no material issue of fact as to whether the merger had closed. In a separate appeal, a different district court judge found the 1998 Van Sickle Order to be controlling and vacated

the bankruptcy court's order granting summary judgment for the Debtors against Knight and Burton. The Debtors appeal the 1998 Van Sickle Order as well as the order reversing summary judgment against Knight and Burton. The Nugents and Knight cross-appeal the bankruptcy court decision. [2]

2 Burton was originally part of the cross-appeal against the Debtors, but has since stipulated to the dismissal of his part of the cross-appeal.

[8]** [HN5]

This Court reviews the district court's decision on an appeal from a bankruptcy **[*828]** court de novo. See Preblich v. Battley, 181 F.3d 1048, 1051 (9th Cir. 1999). The bankruptcy court's grant of summary judgment is also reviewed de novo. See In re Bakersfield Westar Ambulance Inc., 123 F.3d 1243, 1245 (9th Cir. 1997). The bankruptcy court's findings of fact are reviewed for clear error. See In re Weisman, 5 F.3d 417, 419 (9th Cir. 1993).

Debtors argue that the district court's determination that the bankruptcy court erred in finding that the Merger Agreement had closed is a finding of fact subject only to review for clear error. The Nugents contend that the district court made no finding of fact and accepted no evidence on the issue so its determination should be reviewed de novo. As the district court explained, this was not "a purely factual question." Accordingly, its determination should be reviewed de novo. See In re Chang, 163 F.3d 1138, 1140 (9th Cir. 1998) (stating that [HN6] mixed questions of law and fact are reviewed de novo).

II. ANALYSIS

The Nugents raise three arguments for why their claim should not be subordinated to the **[**9]** claims of the Debtors' unsecured creditors: 1) § 510(b) only applies to securities fraud claims; 2) § 510(b) does not apply to their claim since they never enjoyed the "rights and privileges" of stock ownership; and 3) the Merger Agreement never closed, and, therefore, there was not an actual sale or purchase of securities that could trigger mandatory subordination under § 510(b).

A. Mandatory Subordination is Not Limited to Securities Fraud Claims

The Nugents contend that § 510(b) applies only to securities fraud claims. The Nugents argue that because they have not asserted fraud in the issuance of ABS securities, their claims against ABS should not be subordinated. Two cases support the Nugents' position: In re Stern-Slegman-Prins Co., 86 B.R. 994 (Bankr. W.D. Mo. 1988), and In re Amarex, Inc., 78 B.R. 605 (Bankr. W.D. Okla. 1987). In Amarex, limited partners sought damages stemming from a general partner's mismanagement. The limited partners filed claims for breach of contract and common law fraud. The court concluded that the limited partners' claims should not be subordinated. See id. at 609-10 ("Section 510(b) pertains only to **[**10]** claims based upon the alleged wrongful issuance and sale of the security and does not encompass claims based upon conduct by the issuer of the security which occurred after this event."). In the Stern-Slegman case, a shareholder sued to enforce a stock repurchase agreement. The court held that the shareholder claims should not be subordinated. It noted that "every case the Court has found applying [510(b)] involved shareholder claims for rescission or damages based on fraudulent sale of securities." Stern-Slegman, 86 B.R. at 1000.

Recently, however, more courts have interpreted § 510(b), and have decided that [HN7] the statute requires subordination of more than securities fraud claims. See In re NAL Financial Group, Inc., 237 B.R. 225, 234 (Bankr. S.D. Fla. 1999); In re Granite Partners, 208 B.R. 332, 337 (Bankr. S.D.N.Y. 1997) (cautioning against an overly restrictive interpretation of § 510(b) because Congress was concerned with all investor claims against a stock issuer for loss of investment, not just fraudulent issuance claims); In re Public Service Co. of New Hampshire, 129 B.R. 3, 5 (Bankr. D.N.H. 1991) ("Although the **[**11]** claim in this case is largely based on fraud, the language of 510(b) is broad enough to include breach of contract and related actions as well."); In re Lenco, Inc., 116 B.R. 141, 144 (Bankr. E.D. Mo. 1990) (applying § 510(b) in a case that involved no allegations of fraud). In NAL Financial Group, the breach of contract claim at issue arose from the debtor's failure to register debentures as required under a securities purchase agreement. The court explained that the claim would not exist unless the parties had entered into the agreement, **[*829]** which was for the "purchase or sale of a security of the debtor" under § 510(b). Therefore, the statute required that the claim be subordinated. See NAL Financial Group, 237 B.R. at 234.

The recent interpretations of the statute are more persuasive than the two cases cited by the Nugents. Section 510(b)'s legislative history does not reveal an intent to tie mandatory subordination exclusively to securities fraud claims. Congress relied heavily on the analysis of two law professors in crafting the statute. See H. Rep. 95-595, at 195 (1977) (explaining that the argument for mandatory subordination is best described **[**12]** by Slain & Kripke, The Interface Between Securities Regulation and Bankruptcy--Allocating Risk of Illegal Securities Issuance Between Security holders and the Issuer's Creditors, 48 N.Y.U. L. Rev. 261 (1973)); see also Granite Partners, 208 B.R. at 336 ("Any discussion of section 510(b) must begin with the 1973 law review article authored by Professors John J. Slain and Homer Kripke."). According to Slain and Kripke, the dissimilar expectations of investors and creditors should be taken into account in setting a standard for mandatory subordination. Shareholders expect to take more risk than creditors in return for the right to participate in firm profits. The creditor only expects repayment of a fixed debt. It is unfair to shift all of the risk to the creditor class since the creditors extend credit in reliance on the cushion of investment provided by the shareholders. See Granite Partners, 208 B.R. at 336-37. There is nothing in the Slain and Kripke analysis to suggest that Congress's concern with creditor expectations and equitable risk allocation was limited to cases of debtor fraud.

The Nugents alleged that ABS breached the Merger Agreement **[**13]** in failing to convey shares. In a subsequent complaint, their Fifth Amended Complaint, they alleged that the merger never closed, and that ABS unlawfully converted their interest in Betacom. Regardless, their claims are for damages surrounding the sale or purchase of a security of the debtor. Following the Slain and Kripke risk allocation analysis endorsed by Congress, the bankruptcy court decided correctly that the Nugents' claims fell under § 510(b) even though the Nugents did not allege violations of the securities laws.

B. Physical Possession of the Stock is Not Required Under § 510(b)

The Nugents maintain that § 510(b) does not apply to their claims because they never enjoyed the rights and privileges of ownership of ABS stock and that only bonafide shareholder claims come within the ambit of the statute. The Nugents never received any ABS stock or cash for their Betacom shares. For its part, ABS contends that the Nugents enjoyed several benefits under the Merger Agreement including participation in shareholder meetings and the assumption by ABS of Betacom debts personally guaranteed by the Nugents. ABS argues that the Nugents have only themselves to blame for not receiving **[**14]** their stock since they breached the Merger Agreement by refusing to sign a deed of release and thereby forced ABS to keep the shares in escrow.

[HN8] Nothing in § 510(b)'s text requires a subordinated claimant to be a shareholder. See In re Walnut Equipment Leasing Co., 1999 Bankr. LEXIS 1626, 1999 WL 1271762, *6 (Bankr. E.D. Pa. 1999) ("The language of § 510(b) does not limit its application to any particular type of claimant but, rather, focuses on the type of claim possessed."); see also In re THC Financial Corp., 679 F.2d 784, 787 (9th Cir. 1982) (interpreting the Bankruptcy Act to subordinate a claim for shares of escrowed stock that had not been delivered under the terms of a merger agreement). The Nugents argue that application of § 510(b) to non-shareholders would pervert the statute's purpose. They maintain that unless stock ownership is required for mandatory subordination, a corporation **[*830]** could sell stock to an investor for valuable consideration, keep the consideration without delivering the stock, declare bankruptcy the next day, and pay off creditors without paying off the investor.

Here, however, the Nugents waited years to assert their claim for damages for breach of **[**15]** the Merger Agreement and refused to accept tender of the ABS shares when offered. Meanwhile, creditors relied on the Betacom Entities' assets transferred by the Nugents in their decisions to extend credit to ABS. The Slain and Kripke risk analysis embodied in § 510(b) makes just as much sense in the Nugents' situation as it does in the situation of a claimant who physically received her stock certificates, but was defrauded into purchasing them. The Nugents were experienced businesspeople who traded their equity in Betacom for a chance at greater earnings with ABS after its initial public offering. Even though the Nugents never received their stock, it remains true that they decided to enter the Merger Agreement with the understanding that they faced the risk that ABS's IPO could fail and that ABS might go bankrupt.

C. An Actual Sale is Not Required to Subordinate the Nugents' Claim

The Nugents contend that an actual sale or purchase of a security is required for mandatory subordination. If the Merger Agreement never closed, they argue, there was no sale and their claims should not be subordinated. The district court agreed with this argument. It reasoned that in the absence of **[**16]** the equity supplied by a shareholder's investment, creditors could not claim to have relied on that equity in deciding to extend credit. The district court reversed the bankruptcy court's grant of summary judgment requiring subordination of the Nugents'

claims. The district court explained that it was unclear whether ABS had breached the Merger Agreement, and, therefore, it was improper to find at summary judgment that no purchase or sale of securities ever took place.

[HN9] In determining whether or not an actual sale or purchase is required for mandatory subordination, we must examine the reasoning behind § 510(b). There are two main rationales for mandatory subordination: 1) the dissimilar risk and return expectations of shareholders and creditors; and 2) the reliance of creditors on the equity cushion provided by shareholder investment.

The first rationale applies even if there is no "actual" sale or purchase. Before they receive any stock or extend a line of credit, investors and creditors have different expectations. Even if an investor never receives her promised shares, she entered into the investment with greater financial expectations than the creditor. The creditor can only **[**17]** recoup her investment; the investor expects to participate in firm profits. See

Granite Partners, 208 B.R. at 336. The House Report on § 510 follows this logic:

> Placing rescinding shareholders on a parity with general creditors shifts the risk of an illegal stock offering to general creditors. The general creditors have not had the potential benefit of the proceeds of the enterprise deriving from ownership of the securities and it is inequitable to permit shareholders that have had this potential benefit to shift the loss to general creditors.

H. Rep. 95-595 at 195.

The second rationale for not allowing shareholder claimants to take priority over creditor claimants is that creditors may rely on the funds contributed by the shareholders in assessing the risk of their loan to the debtor. The legislative history of § 510 specifically notes this argument in the Slain and Kripke article: "[Slain and Kripke] point out that in the instant case, the unsecured creditor does rely on an apparent cushion of equity securities in making the decision to extend credit." Id.; **[*831]** see Slain & Kripke, supra, at 288 ("a distinction [should] be drawn between general creditors **[**18]** who have relied upon the stockholder's undertaking and those who have not"). According to the district court, even if there is a claim stemming from an agreement to purchase or sell stock, if the stock is never issued to an investor, then future creditors do not rely on the investor's contribution in making their decisions to extend credit and the creditors do not deserve to move ahead of the investors in the bankruptcy line.

The district court's reasoning makes sense, but it does not fit the facts of this case. Some of the Debtors' creditors extended credit after ABS merged with Betacom. Presumably, ABS's creditors noted that ABS now had two new radio stations as assets before deciding to extend credit. According to Slain and Kripke, it is unfair for shareholders to have the same priority in bankruptcy proceedings as these creditors. [3] Without § 510(b), shareholders with a valid claim for damages have the same rights as creditors to recover their investment in the bankrupt firm, the same investment that the creditors relied on when extending credit. The district court's interpretation of § 510(b) to require an actual stock purchase might be valid in some situations, but not in **[**19]** a situation like the one faced by the ABS creditors who relied on the Nugents' contribution when they decided to extend credit. [4]

3

> We propose that each creditor of a distressed enterprise be presumed to have relied upon each prior investment in equity and junior debt. The corollary is that the rescinding investor should be barred from competition with any subsequent creditor unless, and to the extent that, the investor can prove non-reliance by the investor. Slain & Kripke, supra, at 294.

4 On May 21, 1999, in the District Court Litigation, the district court granted partial summary judgment for the Debtors and dismissed the Nugents' constructive trust, fraud, and conversion claims. The district court found that the Nugents' constructive trust claim, which was based on a claim that the merger of Betacom and ABS never closed, was barred by judicial estoppel because the bankruptcy court, the Bankruptcy Appellate Panel, and the district court, acting as an appellate court to the bankruptcy court, had all relied on the

Nugents' repeated assertions that the merger had closed. Judicial estoppel "precludes a party from gaining advantage by taking one position, and then seeking a second advantage by taking an incompatible position." Rissetto v. Plumbers and Steamfitters Local 343, 94 F.3d 597, 600 (9th Cir. 1996). We need not decide whether the district court's application of judicial estoppel was appropriate, since we have already concluded that the Nugents' claims should be subordinated even if the Merger Agreement never actually closed.

[20]** Burton and Knight admit that their situation is "identical" to that of the Nugents. In his order reversing the bankruptcy court's summary judgment decision against Burton and Knight, the district judge explained that Burton and Knight's appeal was controlled by the 1998 Van Sickle Order. Since that order was based on the need for an actual purchase or sale and we hold that an actual purchase or sale is not required for mandatory subordination, the district court's order is reversed and Burton and Knight's claims are subordinated along with the Nugents' claim. Debtors' argument that the district court failed to engage in an "independent analysis" of the Burton and Knight appeal does not need to be addressed.

D. Promissory Notes Claims

In addition to their claim for damages based on breach of the Merger Agreement, the Nugents also filed claims based on promissory notes from Betacom. Without comment, the bankruptcy court appears to have subordinated the two promissory note claims along with the breach of contract claim. The 1998 Van Sickle Order reversing the bankruptcy court fails to mention the two claims. The Nugents contend that even if this Court concludes that their breach of **[**21]** contract claim should be subordinated, the promissory note **[*832]** claims should not be subordinated because they do not arise from the sale or purchase of ABS stock. Since neither the bankruptcy court nor the district court have addressed the note claims and there is little evidence in the record to explain their origin, we remand these two claims to the bankruptcy court. If the promissory note claims are linked to the Merger Agreement, they should be subordinated along with the breach of contract claim.

CONCLUSION

The bankruptcy court properly subordinated the claims of the Nugents and Knight and Burton for breach of contract against the Debtors. The bankruptcy court orders granting partial summary judgment against the Nugents and summary judgment against Knight and Burton are AFFIRMED. The district court orders reversing the bankruptcy court's orders granting summary judgment are REVERSED. The Nugents' claims for damages relating to the two promissory notes are remanded to the bankruptcy court.

TAB 12

In re: MID-AMERICAN WASTE SYSTEMS, INC., et al., Debtors.

Chapter 11, Case No. 97-104 (PJW) (Substantively Consolidated)

UNITED STATES BANKRUPTCY COURT FOR THE DISTRICT OF DELAWARE

228 B.R. 816; 1999 Bankr. LEXIS 27; 33 Bankr. Ct. Dec. 958

January 13, 1999, Decided

DISPOSITION: **[**1]** O&D Claimants administrative expense priority claims disallowed and the Claimants' claims subordinated pursuant to § 510(b) and treated as Class 7 claims in MAWS's Plan.

CASE SUMMARY:

PROCEDURAL POSTURE: The debtor in a bankruptcy action objected to the claimants' proofs of claim on the grounds that the claims should be subordinated pursuant to 11 U.S.C.S. § 510(b) or disallowed and expunged pursuant to 11 U.S.C.S. § 502(e)(1)(B). The debtor also objected to claimant managers' proofs of claim on the ground that their claims should not be not allowable as administrative expense claims pursuant to 11 U.S.C.S. § 503(b)(1)(A).

OVERVIEW: After the debtor filed a Chapter 11 bankruptcy action, it objected to the claimants' reimbursement claims on the grounds that these claims should be subordinated pursuant to 11 U.S.C.S. § 510(b) or disallowed and expunged pursuant to 11 U.S.C.S. § 502(e)(1)(B). The debtor also objected to the claimant managers' indemnification claims on the grounds that they should not be allowable as administrative expenses. Agreeing with the debtor, the court disallowed the claimant managers' indemnification claims as administrative expense claims. These claims were merely claims for prepetition compensation for services rendered, and the claimant managers had not incurred any actual or necessary expenses that would entitle them to indemnification by the debtor under Del. Code Ann. tit. 8, § 145(c). The court subordinated the claimants' reimbursement claims because § 510(b) required the subordination of these claims, both for liability and expenses, inasmuch as they had resulted from securities law claims by purchasers or sellers of the debtor's securities. It was thus proper to treat the claims as unsecured.

OUTCOME: The court disallowed the claimant managers' administrative expense priority claims because these claims were merely claims for services rendered prepetition. The court subordinated the claimants' reimbursement claims because the Bankruptcy Code unambiguously required subordination for liability and expenses resulting from securities law claims by purchasers or sellers of the debtor's securities.

CORE TERMS: claimant, indemnification, shareholder, subordinated, prepetition, administrative expense, reimbursement, subordination, holder, rescission, lawsuit, underwriter's, subordinate, securities law, litigation expenses, unsecured claims, attorneys' fees, postpetition, unsecured creditors, certificate of incorporation, legislative history, indemnify, common stock, indemnity, indemnity claims, purchasers, senior, proof of claim, expenses incurred, damages arising

LexisNexis(R) Headnotes

Bankruptcy Law > Claims > Types > Unsecured Priority Claims > Administrative Expenses > Estate Preservation
Business & Corporate Law > Corporations > Directors & Officers > Compensation > General Overview
Business & Corporate Law > Corporations > Directors & Officers > Management Duties & Liabilities >

Indemnification
[HN1] 11 U.S.C.S. § 503(b)(1)(A) defines administrative expenses as including the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case. It is well established that a company's duty to indemnify officers is a form of compensation.

Bankruptcy Law > Case Administration > Examiners, Officers & Trustees > Postpetition Transactions
Bankruptcy Law > Claims > Types > Unsecured Priority Claims > Administrative Expenses > Estate Preservation
[HN2] To establish administrative priority under 11 U.S.C.S. § 503(b)(1)(A), the claimants must demonstrate that the claimed expenses (i) arose out of a postpetition transaction with the debtor-in-possession and (ii) directly and substantially benefitted the estate. An expense is administrative only if it arises out of a transaction between the creditor and the bankrupt's trustee or debtor in possession and only to the extent that the consideration supporting the claimant's right to payment was both supplied to and beneficial to the debtor-in-possession in the operation of the business. A debt is not entitled to priority simply because the right to payment arises after the debtor in possession has begun managing the estate.

Bankruptcy Law > Claims > Types > Unsecured Priority Claims > Administrative Expenses > Priority
[HN3] An indemnification claim by an officer or director based on that officer's or director's prepetition services is not a claim on account of services rendered after the commencement of a case that is entitled to administrative expense priority.

Bankruptcy Law > Claims > Types > Unsecured Priority Claims > Administrative Expenses > General Overview
[HN4] When parties agree in advance that one party will indemnify the other party in the event of a certain occurrence, there exists a right to payment, albeit contingent, upon the signing of the agreement.

Business & Corporate Law > Corporations > Formation > Corporate Existence, Powers & Purpose > General Overview
Business & Corporate Law > Corporations > Governing Documents & Procedures > Articles of Incorporation & Bylaws > General Overview
[HN5] In Delaware, a corporation's certificate of incorporation creates a contract between the state and the corporation.

Business & Corporate Law > Agency Relationships > Duties & Liabilities > Indemnity
Business & Corporate Law > Corporations > Shareholders > Actions Against Corporations > General Overview
Contracts Law > Contract Conditions & Provisions > Indemnity
[HN6] The Delaware General Corporations Law § 145(c), Del. Code Ann. tit. 8, § 145(c), states that, to the extent that a director, officer, employee, or agent of a corporation has been successful on the merits or otherwise in defense of any action, suit or proceeding referred to in § 145(a) and (b), or in defense of any claim, issue or matter therein, such person shall be indemnified against expenses (including attorneys' fees) actually and reasonably incurred by such person in connection therewith.

Business & Corporate Law > Corporations > Directors & Officers > Management Duties & Liabilities > Indemnification
Business & Corporate Law > Corporations > Shareholders > Actions Against Corporations > General Overview
Insurance Law > Business Insurance > Directors & Officers Liability Insurance > Obligations > Settlements
[HN7] The mandatory indemnification requirement of the Delaware General Corporations Law § 145(c), Del. Code Ann. tit. 8, § 145(c), only springs into existence when the officer or director has been successful on the merits or otherwise in defense of the action. The "or otherwise in defense" language contemplates a negotiated settlement in which the suit is dismissed with prejudice and without any payment or assumption of liability by the officer or director.

Bankruptcy Law > Claims > Allowance
Bankruptcy Law > Claims > Types > Unsecured Priority Claims > Subordination
[HN8] 11 U.S.C.S. § 510(b) provides that, for the purpose of distribution under title 11, a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under 11 U.S.C.S. § 502 on

account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock.

Governments > Legislation > Interpretation
[HN9] If the language of a statute is unambiguous, the court's inquiry ends. However, if the language is ambiguous, or if the literal application of the plain meaning will produce a result demonstrably at odds with the intention of its drafters, then the intent of Congress needs to be examined in construing the statute's meaning.

Bankruptcy Law > Claims > Types > Unsecured Priority Claims > Subordination
Securities Law > Blue Sky Laws > Offer & Sale
[HN10] 11 U.S.C.S. § 510(b) intends to subordinate the indemnification claims of officers, directors, and underwriters for both liability and expenses incurred in connection with the pursuit of claims for rescission or damages by purchasers or sellers of the debtor's securities.

Bankruptcy Law > Claims > Types > Unsecured Priority Claims > Subordination
[HN11] See 11 U.S.C.S. § 510(b).

Bankruptcy Law > Claims > Types > Unsecured Priority Claims > Subordination
Securities Law > Blue Sky Laws > Offer & Sale
[HN12] 11 U.S.C.S. § 510(b) applies to claims arising from rescission or damages from the purchase or sale of a security. The Bankruptcy Code defines the term "security" to include a "note," "bond," or "debenture." 11 U.S.C.S. § 101(49)(A)(i), (iv), (v). Thus, by its plain terms, § 510(b) is intended to apply to both debtholders and equityholders.

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JUDGES: Peter J. Walsh, J.

OPINION BY: Peter J. Walsh

OPINION

[*818] MEMORANDUM OPINION

Peter J. Walsh

J.

Before the Court are the objections (Doc. # 760, 761, 795) of reorganized debtor Mid-American Waste Systems,

Inc. ("MAWS") to (i) the proofs of claim filed by MAWS's former officers and directors John D. Peckskemp, R. Jay Roberts, Christopher L. White, Richard A. Nidders, Jr., and Dennis P. Wilburn (collectively the "O&D Claimants"), (ii) the proof of claim of NatWest Capital Markets Limited ("NatWest"), and (iii) the proof of claim of Donaldson, Lufkin, & Jenerette ("DLJ", and together with the O&D Claimants and Natwest, the "Claimants"). MAWS objects to the claims on the grounds that they should be subordinated pursuant to § 510(b) of the Bankruptcy Code, [1] or, alternatively, they should be disallowed and expunged pursuant to § 502(e)(1)(B). In addition, MAWS objects to the O&D Claimants' claims on the ground that their claims are not allowable as administrative expense claims under § 503(b)(1)(A). For the reasons given below, I find that the Claimants' claims **[**3]** should be treated as unsecured subordinated claims pursuant to § 510(b). Because subordinated claims under MAWS' liquidating plan are not entitled to any distribution, I need not reach the alternative issue of whether the claims should be disallowed pursuant to § 502(e)(1)(B).

1 All references to "§ " refer to a section of the Bankruptcy Code, 11 U.S.C. § 101 *et seq.*

FACTS

MAWS was formed in December 1985 to acquire and operate solid waste collection operations and landfills. MAWS commenced operations in January 1986 and rapidly expanded through the acquisition of more than 127 collection operations, transfer stations, and preexisting collection services.

In May 1994, MAWS obtained a $ 75 million unsecured credit facility provided by three lenders. As contemplated by the facility, MAWS effected a public issuance of $ 175 million of 12.25% Senior Subordinated Notes due 2003 (the "Notes"). Pursuant to an underwriting agreement dated May 17, 1994, NatWest and DLJ served as underwriters **[**4]** for MAWS in connection with the offering of the Notes. Section 6 of the underwriting agreement contains an indemnification clause which provides that

> (a) The Issuers [i.e., MAWS], jointly and severally, agree to indemnify and hold harmless [DLJ and NatWest] to the fullest extent lawful, from and against any and all losses, claims, damages, liabilities, judgments, actions and expenses (including without limitation and as incurred, reimbursement of all reasonable costs of investigating, preparing, pursuing or defending any claim or action . . . commenced or threatened, including the reasonable fees and expenses of counsel to [DLJ and NatWest]) directly or indirectly caused by, related to, based upon, arising out of or in connection with any untrue statement or alleged untrue statement of a material fact contained in the Registration Statement . . . or the Prospectus. . . .
>
> (b) [DLJ and NatWest] shall have the right to employ its own counsel in any such action and the fees and expenses of such counsel shall be paid, as incurred, by the Issuers (regardless of whether it is ultimately determined that [either DLJ or NatWest] is not entitled to Indemnification **[*819]** hereunder). **[**5]** The Issuers shall not, in connection with any one such action or proceeding or separate but substantially similar or related actions or proceedings in the same jurisdiction arising out of the same general allegation or circumstances, be liable for the reasonable fees and expenses of more than one separate firm of attorneys . . . at any time for [DLJ or NatWest].

In early 1996, following allegations of wrongful conduct by existing management, MAWS conducted a review of its operations and financial condition and discovered that its assets were impaired by approximately $ 186 million and that closure and postclosure costs had been underaccrued by $ 19 million. Such impairment and underaccruals were in addition to $ 196 million of impairments and losses and $ 70 million in underaccrued closure and postclosure expenses recorded during the 1995 fiscal year. Prior to its Chapter 11 filing, MAWS took write downs on their financial statements of over $ 470 million to account for overstatements of asset values and understatements of amortization costs and accrued closure and postclosure obligations.

During the period January 17, 1997 through April 16, 1997, certain holders of the Notes **[**6]** commenced the following actions against certain of the Claimants and others:

> (i) *Federated Management et al. v. Coopers & Lybrand, LLP*, Court of Common Pleas, Franklin County, Ohio, Case No. 97CVH-01-2196, filed January 24, 1997 (the "Ohio Lawsuit");
>
> (ii) *Canyon Capital Management, L.P. et al. v. Coopers & Lybrand, LLP et al.*, United States District Court for the Southern District of Ohio, Eastern Division, Case No. C2 97-419, filed April 14, 1997 ("Canyon I");
>
> (iii) *Canyon Capital Management, L.P. et al. v. Coopers & Lybrand, LLP et al.*, Court of Common Pleas, Franklin County,

Ohio, Case No. 97CVH04-4481, filed April 16, 1997 ("Canyon II").

Each lawsuit named former officers and directors Christopher White, Dennis P. Wilburn, and Richard A. Widders as defendants. The Ohio Lawsuit was later amended to add former director Richard Jay Roberts as a defendant. The Ohio Lawsuit also named DLJ and NatWest as defendants. [2]

2 Several of the proofs of claim refer to *Corporate High Yield Fund, Inc. et al. v. Coopers & Lybrand, LLP et al.*, United States District Court for the District of New Jersey, Civil Action No. 97-325 (AJL), filed January 17, 1997 (the "New Jersey Lawsuit"), which had named DLJ and NatWest as defendants. Pursuant to a stipulation of settlement, the New Jersey Lawsuit was dismissed with prejudice and without any payment by the O&D Claimants to the plaintiffs in the action.

[7]** The plaintiffs allege causes of action for false representations and omissions in the registration statement, prospectus and financial statements filed with the SEC in connection with the sale of the Notes. The plaintiffs generally assert claims under Ohio securities laws, common law fraud, aiding and abetting common law fraud, negligent misrepresentation, breach of contract, breach of fiduciary duty/acting in concert, negligence and violations of sections 11, 12, 15 and 17 of the Securities Act of 1933. The Canyon I complaint also alleges causes of action pursuant to sections 10(b), 18 and 20(a) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. The plaintiffs seek rescission of the plaintiffs' purchases of the Notes, unliquidated actual damages and punitive damages. The Canyon I complaint also seeks disgorgement of profits. No judgment has been rendered in any of these lawsuits and they are still pending.

On April 22, 1997, certain equityholders commenced the following action against, *inter alia*, former officers and directors White, Wilburn and Widders:

Bovee et al. v. Coopers & Lybrand, LLP et al., United States District Court for the Southern District **[**8]** of Ohio, Eastern Division, Case No. C2 97-449, filed April 22, 1997 (the "Equityholders Lawsuit", and together with the Ohio Lawsuit, the Canyon I Lawsuit, and the Canyon II Lawsuit, the "Securities Litigation").

The Equityholders Lawsuit is a class action complaint brought by purchasers of MAWS common stock during the period April 4, 1995 **[*820]** through January 21, 1997. The complaint alleges that the defendants either knowingly or recklessly published or disseminated false financial statements and data causing the plaintiffs to buy MAWS stock at artificially high prices and suffer losses. The complaint asserts causes of action for violations of sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and SEC Rule 10b-5, as well as for negligence and negligent misrepresentation.

On January 21, 1997, MAWS and its thirty-one subsidiaries filed voluntary petitions for relief under Chapter 11 of the Bankruptcy Code. On that date, MAWS filed a motion for approval of the sale of substantially all of their assets to USA Waste Services, Inc. That sale was subsequently approved, and thereafter the Court approved MAWS's Amended Joint Liquidating Plan of Reorganization (the "Plan"). **[**9]** The Plan provides for payment in full of class 1 administrative claims, partial payment for class 4 unsecured claims, and no payout to holders of class 7 subordinated claims. (Doc. # 541 at 18-25)

The O&D Claimants assert indemnification claims based on both MAWS's Certificate of Incorporation and on Delaware corporation law, 8 *Del. C.* § 145(c). The Certificate of Incorporation indemnification provision reads:

> The corporation will indemnify or agree to indemnify any person who was or is a party, or is threatened to be made a party to any threatened, pending, or completed action or suit by or in the right of the corporation to procure a judgment in its favor by reason of the fact that he is or was a director, officer, employee, or agent of the corporation, or is or was serving at the request of the corporation as director, trustee, officer, employee, or agent of another corporation (including a subsidiary of this corporation), domestic or foreign, nonprofit or for profit, partnership, joint venture, trust, or other enterprise against expenses, including attorneys' fees, actually and reasonably incurred by him in connection with the defense or settlement of such action **[**10]** or suit if he acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interest of the corporation, except that no indemnification shall be made in respect to any claim, issue, or matter as to which such person shall have been adjudged to be liable to the corporation unless, and only to the extent that, the Court of Chancery, or the court in which such action or suit was brought shall determine upon application that, despite the adjudication of liability, but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses as the Court of Chancery or other such court shall deem proper.

(Doc. # 761 at 7)

The O&D Claimants were senior members of the MAWS management team. Several of the O&D Claimants were never employed postpetition, having resigned prior to MAWS's bankruptcy filing. All of the facts and circumstances which form the basis of the claims against the O&D Claimants in the Securities Litigation occurred prior to MAWS's bankruptcy filing. Each O&D Claimant lists his claim as an administrative expense claim.

NatWest and DLJ filed proofs of claim which seek, as general unsecured **[**11]** claims, (i) unliquidated damages pursuant to paragraph 6 of the underwriting agreement and section 11(f) of the Securities Act of 1933; and (ii) damages on account of fees, including attorneys' fees, and costs and expenses of defending the Securities Litigation that have already accrued (for NatWest, a liquidated amount of $ 455,283.22; for DLJ, a liquidated amount of $ 207,829.83) and that have not yet accrued.

MAWS objects to the Claimants' claims on the grounds that the claims should be subordinated pursuant to § 510 (b) of the Bankruptcy Code, or, alternatively, that they should be disallowed and expunged pursuant to § 502(e)(1)(B). (Doc. # 760, 761, 795) In addition, MAWS objects to the O&D Claimants' claims on the ground that their claims are not allowable as administrative expense claims under § 503(b)(1)(A). The Claimants filed responses (Doc. # 802, 805, 837), MAWS filed replies thereto (Doc. # 860, 867, 868), and the Court heard oral argument on the matter.

[*821] DISCUSSION

The O&D Claimants' Claims as Administrative Expense Claims

The O&D Claimants seek administrative expense priority for their indemnification claims against MAWS. They claim that, citing **[**12]** *Avellino & Bienes v. M. Frenville Co. (In re M. Frenville Co.)*, 744 F.2d 332 (3d Cir. 1984), "a claim against a debtor for indemnification or contribution arising from litigation commenced against the creditor postpetition constitutes an administrative claim." (Doc. # 802 at 6) Although the O&D Claimants seek an administrative expense priority payment, their brief does not discuss, or even identify § 503(b)--the governing statutory provision.

[HN1] Section 503(b)(1)(A) defines administrative expenses as including "the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case." It is well established that a company's duty to indemnify officers is a form of compensation. *Christian Life Center Litig. Defense Comm. v. Silva (In re Christian Life Center)*, 821 F.2d 1370, 1373 (9th Cir. 1987)("A corporation's duty to indemnify its officer, whether conferred by statute or by contract, is a form of compensation for the officer's services.") (citing *In re Baldwin-United Corp.*, 43 B.R. 443, 454-56 (S.D. Ohio 1984)); *see also In re Philadelphia Mortgage Trust*, 117 B.R. 820, 827 (Bankr. **[**13]** E.D. Pa. 1990); *In re Consolidated Oil & Gas, Inc.*, 110 B.R. 535, 537 (Bankr. D. Colo. 1990); *In re Amfesco Indus., Inc.*, 81 B.R. 777, 784 (Bankr. E.D.N.Y. 1988).

[HN2] To establish administrative priority under § 503(b)(1)(A), the O&D Claimants must demonstrate that the claimed expenses (i) arose out of a postpetition transaction with the debtor-in-possession and (ii) directly and substantially benefitted the estate. *Microsoft Corp. v. DAK Indus., Inc. (In re DAK Indus., Inc.)*, 66 F.3d 1091, 1094 (9th Cir. 1995); *In re Molnar Bros.*, 200 B.R. 555, 559 & n.3 (Bankr. D.N.J. 1996). As the Second Circuit has stated:

> An expense is administrative only if it arises out of a transaction between the creditor and the bankrupt's trustee or debtor in possession and "only to the extent that the consideration supporting the claimant's right to payment was both supplied to and beneficial to the debtor-in-possession in the operation of the business." A debt is not entitled to priority simply because the right to payment arises after the debtor in possession has begun managing the estate.

Trustees of Amalgamated Ins. Fund v. McFarlin's, Inc., 789 F.2d 98, 101 (2d Cir. **[**14]** 1986) (quoting *In re Mammoth Mart, Inc.*, 536 F.2d 950, 954 (1st Cir. 1976)) (citations omitted).

I do not perceive a postpetition transaction between MAWS and the O&D Claimants as having occurred here. The O&D Claimants were each employed prepetition by MAWS. The O&D Claimants' conduct which forms the basis for the Shareholder Litigation all arose out of their prepetition activities as officers and/or directors of MAWS. The

indemnification provisions upon which the O&D Claimants base their claims were in place during the entire prepetition relevant period and covered the O&D Claimants throughout the prepetition period in which the conduct at issue occurred.

[HN3] An indemnification claim by an officer or director based on that officer's or director's prepetition services is not a claim on account of "services rendered after the commencement of a case" that is entitled to administrative expense priority. Instead, the O&D Claimants' indemnification claims are merely claims for prepetition compensation for services rendered, not unlike salary or other benefits. *See, e.g., Christian Life*, 821 F.2d at 1373 (holding that officers' indemnity/contribution claims for litigation costs were **[**15]** not an administrative expense because litigation was based on prepetition services and conduct); *Baldwin-United*, 43 B.R. at 454-56 (holding that directors and officers' claims based on debtor's bylaws for indemnity of costs of defending against allegations of misconduct during their tenure on prepetition debtor's board of directors were not compensable as administrative claims); *Philadelphia Mortgage*, 117 B.R. at 828 ("Claims of corporate officers for indemnification and compensation **[*822]** for pre-petition actions based upon corporate by-laws or resolutions . . . have consistently been denied administrative status due to findings by courts that such claims are pre-petition claims because the acts or services which gave rise to them were performed pre-petition."); *Amfesco*, 81 B.R. at 781 ("All of the operative facts, legal relationships, and conduct of the Applicants upon which is based the threatened litigation occurred prepetition. . . . Any duty of the Debtors to indemnify the Applicants arises from services provided to the pre-petition Corporation not for services rendered post-petition to the Debtors-in-Possession."); *Consolidated Oil*, 110 B.R. at 537 (holding that corporate **[**16]** officers and directors were not entitled to administrative expense priority on their right to indemnification for legal fees founded on state law, the debtor's articles of incorporation and bylaws, and employment contracts where the officers and directors performed no postpetition services for the debtor and the litigation, commenced postpetition, was based on prepetition conduct); *cf. In re Heck's Properties, Inc.*, 151 B.R. 739, 767 (S.D. W. Va. 1992) (holding that debtor's officers and directors were entitled to administrative claim for indemnity or contribution for litigation costs pursuant to debtor's articles of incorporation because claim against officers and directors "related solely to postpetition conduct and services").

In their brief, the O&D Claimants state that each O&D Claimant timely filed a proof of claim stating that "the Claim is entitled to administrative priority status in accordance with *In re M. Frenville Co.*" (Doc. # 802 at 3-4) The O&D Claimants reliance on *Frenville* is misplaced. In *Frenville*, the Third Circuit held that an accounting firm's indemnification suit against the debtor, which arose as a result of a postpetition suit filed by defrauded **[**17]** security holders against the accountants but which implicated the accountants' prepetition conduct, constituted a postpetition claim because the accountants' "right to payment" arose only at the time the security holders' suit was filed. *Frenville*, 744 F.2d at 337. Thus, the court simply held that the automatic stay provisions of § 362(a), which require that a stayed proceeding "was or could have been commenced" before filing, did not apply to the accountants' suit for indemnification. *Id. Frenville* did not involve an administrative expense claim.

More importantly, the *Frenville* court distinguished the third-party action at issue in that case from the example of a prepetition contingent claim in surety relationships. *Id.* at 336-37. The court reasoned that " [HN4] when parties agree in advance that one party will indemnify the other party in the event of a certain occurrence, there exists a right to payment, albeit contingent, upon the signing of the agreement." *Id.* at 336-37 (footnote omitted). In the case at bar, the O&D Claimants' indemnification rights are akin to a surety relationship created by MAWS's prepetition certificate of incorporation, under which the O&D **[**18]** Claimants are indemnified for certain prepetition conduct in the performance of their employment services. The only difference between the example given in *Frenville* and the certificate of incorporation at issue in the case at bar is the signing of an agreement. However, the corporation's commitment to indemnify, as provided in the certificate of incorporation, existed at the time each of the O&D Claimants' commenced employment, a fact of which the O&D Claimants were likely aware. The O&D Claimants now rely on its prepetition existence for their indemnification claims. In my view, the absence of a signed agreement is a technical nicety that makes no substantive difference between the prepetition surety agreement addressed in *Frenville* and the prepetition indemnity commitment in MAWS's certificate of incorporation.

The O&D Claimants argue that the certificate of incorporation is not a contract. To reach the conclusion that the certificate of incorporation created a contract on its effective date, the O&D Claimants argue, would produce the illogical result of granting the O&D Claimants a right to payment prior to their employment by MAWS.

[HN5] In Delaware, a corporation's certificate **[**19]** of incorporation creates a contract between the state and the corporation. *See, e.g., Staar Surgical Co. v. Waggoner*, 588 A.2d 1130, 1136 (Del. 1991). At a minimum, **[*823]** the O&D Claimants are third-party beneficiaries of that contract and those benefits come into existence as to each officer and director when each of them become an officer or director of MAWS. The O&D Claimants could hardly

deny their status as third party beneficiaries given that their claim of indemnification rights is founded in that contract. Their relationship to MAWS is akin to the surety relationship which the *Frenville* court stated created a surety right prepetition.

In addition to the indemnification clause of the certificate of incorporation, the O&D Claimants assert that they are entitled to indemnification based on [HN6] § 145(c) of the Delaware General Corporations Law ("DGCL"), 8 *Del. C.* § 145(c), which states that

> to the extent that a director, officer, employee, or agent of a corporation has been successful on the merits or otherwise in defense of any action, suit or proceeding referred to in subsections (a) and (b) of this section [which include the claims asserted in the Shareholder Litigation], **[**20]** or in defense of any claim, issue or matter therein, such person shall be indemnified against expenses (including attorneys' fees) actually and reasonably incurred by such person in connection therewith.

[HN7] The mandatory indemnification requirement of § 145(c) of the DGCL only springs into existence when the officer or director has been "successful on the merits or otherwise in defense" of the action. The "or otherwise in defense" language contemplates a negotiated settlement in which the suit is dismissed with prejudice and without any payment or assumption of liability by the officer or director. *See Wisener v. Air Express Int'l Corp.*, 583 F.2d 579 (2d Cir. 1978); *B & B Inv. Club v. Kleinert's, Inc.*, 472 F. Supp. 787 (E.D. Pa. 1979).

The O&D Claimants identify only one such case involving them that has been dismissed with prejudice pursuant to a stipulation of settlement under which the O&D Claimants made no payment to the plaintiffs. (Doc. # 802 at 4) However, MAWS asserts that all costs and fees incurred in connection with the Securities Litigation have been covered by MAWS's directors and officers insurance policy. (Doc. # 761 at 7-8) Because the O&D Claimants do **[**21]** not challenge this assertion, I conclude that the O&D Claimants have not yet incurred any actual or necessary expenses that would entitle them to indemnification under § 145(c) of the DGCL.

The Claimants' Claims as Class 7 Subordinated Claims Pursuant to § 510(b)'s Subordination Provision

MAWS seeks to classify the Claimants' claims as Class 7 subordinated claims pursuant to [HN8] § 510(b), which provides that

> for the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, *except that if such security is common stock, such claim has the same priority as common stock.*

MAWS argues that Claimants' claims are for "reimbursement" within the contemplation of § 510(b) and are therefore subordinated. NatWest and DLJ make two primary arguments against the application of § 510(b) to **[**22]** their claims: (i) the language of § 510(b) is ambiguous, and it does not encompass indemnification claims for liability and/or litigation expenses incurred by underwriters; and (ii) subordinating indemnification claims for litigation expenses of underwriters under § 510(b) is in conflict with the legislative purpose of § 510(b). [3] The O&D Claimants **[*824]** do not address the § 510(b) issue beyond stating that its administrative expense claims can not be subordinated under § 510(b). However, as stated above, I find that the O&D Claimants' claims are not allowable as administrative expense claims.

3 NatWest and DLJ appear to take differing stances on what parts of their claim to which § 510(b) does not apply. NatWest argues that both its potential liability in the Securities Litigation, as well as its expenses incurred in that litigation, are not included within § 510 (b)'s scope, asserting that "section 510(b) was designed to subordinate the claims of owners of securities, not claims relating to liabilities and expenses incurred by an underwriter such as NatWest in connection with securities litigation." (Doc. # 805 at 6) Although DLJ fully adopts NatWest's position and asserts that "no part of DLJ's claim should be subordinated under § 510(b)," (Doc. # 837 at 4) DLJ appears to argue only for excluding its attorneys' fees from § 510(b)'s scope, conceding that, under § 510(b), "only claims for indemnification of liability are claims that are 'allowed . . . on account of' a 'damages' claim in the securities fraud action." (Doc. # 837 at 5)

[23]** To determine the meaning of § 510(b), I must first look to its language and determine if the language of the statute is ambiguous. *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 242, 103 L. Ed. 2d 290, 109 S. Ct. 1026 (1989). [HN9] If the language is unambiguous, the inquiry ends. *Id.* However, if the language is ambiguous,

or if the literal application of the plain meaning "will produce a result demonstrably at odds with the intention of its drafters," then the intent of Congress needs to be examined in construing the statute's meaning. *Id.*

As discussed below, I find that the plain language of § 510(b), its legislative history, and applicable case law clearly show that [HN10] § 510(b) intends to subordinate the indemnification claims of officers, directors, and underwriters for both liability and expenses incurred in connection with the pursuit of claims for rescission or damages by purchasers or sellers of the debtor's securities. The meaning of amended § 510(b), specifically the language "for reimbursement or contribution . . . on account of [a claim arising from rescission or damages arising from the purchase or sale of a security]," can be discerned by a plain reading **[**24]** of its language.

Prior to its amendment in 1984, § 510(b) provided that

> any claim for recission [sic] of a purchase or sale of a security of the debtor or of an affiliate or for damages arising from the purchase or sale of such a security shall be subordinated for purposes of distribution to all claims and interests that are senior or equal to the claim or interest represented by such security.

In 1984, Congress amended § 510(b), which now reads as follows:

> [HN11] For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock. [4]

4 Comparison of the old and the new § 510(b) is shown by the following--the added language underlined and deleted language in brackets:

> *For the purpose of distribution under this title*, [any] *a* claim [for] *arising from* rescission of a purchase or sale of a security of the debtor or of an affiliate *of the debtor* [or] , for damages arising from the purchase or sale of such a security*, or for reimbursement or contribution allowed under section 502 on account of such a claim,* shall be subordinated [for purposes of distribution] to all claims or interests that are senior *to* or equal [to] the claim or interest represented by such security, *except that if such security is common stock, such claim has the same priority as common stock.*

[25]** NatWest correctly points out that Congress's 1984 amendment to § 510(b) was not accompanied by any legislative history. NatWest argues that amended § 510(b) is ambiguous and posits its view of the legislative history of the original version of the section to conclude that Congress could not have intended the result argued for by MAWS. In support of its position, NatWest repeatedly stresses its view of why the original § 510(b) was enacted:

> The purpose of section 510(b) is to prevent *shareholders* from bootstrapping low priority equity interests into higher priority unsecured claims merely by claiming some sort of fraud in connection with the issuance of the securities.

(Doc. # 805 at 6)

> Congress enacted section 510(b) to prevent equity holders from subverting the **[*825]** absolute priority rule and being treated as general unsecured creditors . . . .

(Doc. # 805 at 7)

> The primary rationale for section 510(b) subordination is that shareholders buy into a particular, subordinate position and should not be able to elevate their claims by suing for recision [sic].

(Doc. # 805 at 10)

> It is abundantly clear that the purpose of section 510(b) is to **[**26]** prevent shareholders from being treated like creditors.

(Doc. # 805 at 12)

From this premise, Natwest argues that this purpose

> is in no way furthered by the subordination of liability and litigation expense claims of an underwriter such as NatWest. NatWest did not bargain for the shareholder suits nor for the expense it is required to incur to defend itself; it is not in the same position as the shareholders whose claims Congress intended to subordinate by virtue of section 510(b). Accordingly, NatWest's claim should be treated just as all other general unsecured claims, and not subordinated as if it was a shareholder's claim.

(Doc. # 805 at 10-11)

NatWest's conclusion is premised on too narrow a focus of the purpose of § 510(b). Although it is correct that the principal focus of Congress in 1978 was to subordinate shareholder securities law claims, Congress's intent was not so limited. [5] In its original adoption, Congress did not limit the application of § 510(b) to equity securities. [HN12] Section 510(b) applies to claims arising from rescission or damages from the purchase or sale of a "security." The Bankruptcy Code defines the term "security" to include **[**27]** a "note," "bond," or "debenture." § 101(49)(A)(i), (iv), (v). Thus, by its plain terms § 510(b) is intended to apply to both debtholders and equityholders. *See Levine v. Resolution Trust Corp. (In re Coronet Capital Co.)*, 1995 U.S. Dist. LEXIS 10175, 1995 WL 429494, *8 (S.D.N.Y. July 20, 1995) (citing *Kira v. Holiday Mart, Inc. (In re Holiday Mart, Inc.)*, 715 F.2d 430, 434 (9th Cir. 1983), for the proposition that § 510(b) is "written in terms of 'any claim for rescission of a purchase or sale of a security' without distinction between equity securities and debt securities" and "commentators have construed the statute to apply to both."). [6] In the case before me, we have both Noteholder claims and shareholder claims.

5 Although the reported decisions and most of the literature on § 510(b) speak in terms of securities law claims by purchasers and sellers, the claims contemplated by § 510(b) can also be based on other case law and statutory law dealing with fraudulent conduct generally, breach of fiduciary duty and similar types of misconduct. For purpose of convenience, I will simply refer to all these claims as securities law claims--the type of claim we see most often in the § 510(b) context.

[28]**

6 The legislative history makes clear that Congress made no mistake in using the Bankruptcy Code defined term "security:"

> The . . . subordination varies with the claim or interest involved. If the security is a debt instrument, the damages or rescission claim will be granted the status of a general unsecured claim. If the security is an equity security, the damages or rescission claim is subordinated to all creditors and treated the same as the equity security itself.

H.R. Rep No. 595, at 359 (1977); S. Rep. No. 989, at 74 (1978)

The legislative history of the original § 510(b) reflects Congress's intent to include security holders' claims generally--both debtholder claims as well as shareholder claims. Discussing a 1973 law review article authored by Professors John J. Slain and Homer Kripke, Congress stated that

> [Professors Slain and Kripke] conclude that allocation of assets in a bankruptcy case is a zero-sum situation, and that rules of allocation in bankruptcy should be predictated on allocation of risk. The two risks to be considered are the risk of insolvency **[**29]** of the debtor and the risk of an unlawful issuance of securities. While both security holders and general creditors assume the risk of insolvency, Slain and Kripke conclude that the risk of illegality in securities issuance should be borne by those investing in securities and not by general creditors.

H.R. Rep. No. 595, at 195 (1977).

Thus, it is readily apparent that the rationale for § 510(b) is not limited to preventing **[*826]** shareholder claimants from improving their position vis-a-vis general creditors; Congress also made the decision to subordinate based on risk allocation. Consequently, when Congress amended § 510(b) to add reimbursement and contribution claims, it was not radically departing from an equityholder claimant treatment provision, as NatWest suggests; it simply added to the subordination treatment new classes of persons and entities involved with the securities

transactions giving rise to the rescission and damage claims. The 1984 amendment to § 510(b) is a logical extension of one of the rationales for the original section--because Congress intended the holders of securities law claims to be subordinated, why not also subordinate claims of other parties **[**30]** (e.g., officers and directors and underwriters) who play a role in the purchase and sale transactions which give rise to the securities law claims? As I view it, in 1984 Congress made a legislative judgment that claims emanating from tainted securities law transactions should not have the same priority as the claims of general creditors of the estate.

Adhering to its narrow understanding of the original purpose of § 510(b), NatWest argues that "broadening the scope of 510(b) to include claims of parties other than shareholders would signal a major expansion of the scope and purpose of section 510(b)." (Doc. # 805 at 11) It offers a "more likely" explanation:

> A more likely explanation is that Congress modified section 510(b) in furtherance of its original purpose: to prevent shareholders from bootstrapping a securities claim into a general unsecured claim. For example, if a shareholder had *some sort of* reimbursement or contribution claim as a result of the decrease in value of the shareholders' securities *that did not arise from the purchase or sale of a security*, such as a *contractual right* to indemnification independent of the purchase of the security, such shareholder **[**31]** could convert *its securities claim* into a general unsecured claim by pursuing its rights under the indemnification contract. In order to further the purpose of section 510(b), the amendment *could have been designed* to guard against such bootstrapping by subordinating all securities-related claims of shareholders, regardless of the source of such claims. (Doc. # 805 at 11) (emphasis added)

I find this argument to be a speculative exercise and in conflict with the plain language of § 510(b). It is pure speculation to suggest that Congress had in mind "some sort of reimbursement or contribution claim as a result of the decrease in the value of the shareholders' securities." I have great difficulty in applying this concept to any type of shareholder/corporation transaction of which I am familiar. Indeed, I find a right of contribution to be an alien element in such a shareholder/corporation transaction. And because there is no 1984 amendment legislative history to aid in a search for meaning beyond the plain words of § 510(b), NatWest's argument cannot be seriously considered.

Furthermore, as I read it, the "some sort" of claim suggested by NatWest is not a securities **[**32]** law claim; it is a contract claim not within the scope of § 510(b). Section 510(b) covers claims that arise in connection with a purchase or sale of a security. NatWest's theoretical claim, as it states it in the above quote, "did not arise from the purchase or sale of a security."

The few reported decisions that address the issue before me support the conclusion that the Claimants' claims are subject to § 510(b)'s subordination. NatWest and DLJ cite the Ninth Circuit's decision in *Christian Life Center Litig. Defense Comm. v. Silva (In re Christian Life Center)*, 821 F.2d 1370 (9th Cir. 1987), for the proposition that § 510(b) does not require subordination of indemnity claims for the costs of defending security holder litigation, while MAWS counters that a later decision out of the Ninth Circuit, *Official Comm. Of Unsecured Creditors v. PaineWebber Inc. (In re De Laurentiis Entertainment Group)*, 124 B.R. 305, 308 (C.D. Cal. 1991), holds that § 510 (b) requires subordination of such litigation cost claims.

In *Christian Life*, a church raised funds for church construction by selling shares in a trust fund. *Christian Life*, 821 F.2d at 1372. A group of trust fund purchasers **[**33]** sued the **[*827]** church and its pastor for fraud and securities law violations after failing to recover their investment, and the church subsequently filed a bankruptcy petition. *Id.* The fraud claim against the pastor was tried and a jury found him not liable. *Id.* After trial, LDC, the group of attorneys representing the pastor and the other officers, submitted a claim against the estate for indemnity of the pastor's defense costs as a first priority administrative expense. *Id.* The bankruptcy court allowed the claim. *Id.* The creditors' committee and other creditors appealed. *Id.* The district court disallowed LDC's claim as an administrative expense and subordinated the indemnity claim to general creditors' claims. *Id.* LDC appealed. *Id.*

After deciding that LDC's claim was not allowable as an administrative expense, the *Christian Life* court took up the issue of whether the district court properly subordinated the claim pursuant to preamended § 510(b). [7] In so doing, the court looked to the purpose of § 510(b), which the court described as

> preventing equity stockholders or holders of other subordinated securities from converting their interests into **[**34]** higher priority general creditors' claims by asserting damages or rescission claims. Congress requires subordination of such claims because failure to subordinate the interests of shareholders to those of unsecured creditors would defeat the reasonable expectations of both. General creditors rely on the equity cushion created by the investment of shareholders and expect priority in bankruptcy. Shareholders in turn bargain for potential profit in exchange for expected subordination of their interests in bankruptcy. [8]

Id. at 1375 (citations omitted).

7 The court recognized Congress's 1984 amendment to § 510(b), which added, *inter alia*, the "reimbursement or contribution" language, *see supra*. The court stated that "we need not and do not determine whether amended section 510(b) requires subordination of indemnity claims." *Id.* at 1375 n.6.

8 I note that the *Christian Life* court, like NatWest, focuses on § 510(b)'s purpose to prevent elevating shareholders into creditor positions. As discussed below, to some extent the *DeLaurentiis* court follows *Christian Life* in that regard. Although § 510(b) obviously covers defrauded shareholders' claims, as noted above, its purpose is not so limited. Congress clearly intended that debenture purchasers (*i.e.*, creditors, not shareholders) having securities law claims also are to be subordinated to general unsecured creditors. Understanding this (as discussed in more detail above at pages 22-26), it seems to me, makes it easier to understand the 1984 amendment to § 510(b) and why that amendment does not reflect a serious departure from its predecessor. Indeed, this may explain why Congress saw no need to make a legislative record in enacting the amendment.

[35]** The court then explored the committee's argument that those stated principles require the claim to be subordinated under § 510(b). The committee argued that if shareholders recovered damages from an officer of the debtor, and the officer in turn recovered by way of indemnity from the estate as an unsecured claimant, the shareholders would achieve indirectly what § 510(b) prevents them from achieving directly, thus avoiding the subordination of their equity interests and defeating the expectations of unsecured creditors. *Id.* at 1375-76. The court rejected the committee's argument because the claims at issue in the case were for litigation costs, not for reimbursement for an officer's liability to security holders. *Id.* at 1376. The court stated that "security holders recover[] nothing from the officers when the latter are merely indemnified for defense costs." *Id.* The court then ended its discussion by concluding that § 510(b) did not require subordination of indemnity claims for defense costs. *Id.*

In *De Laurentiis*, PaineWebber had entered into a series of underwriting agreements with the debtor, which included promises by the debtor that it would reimburse **[**36]** PaineWebber for litigation expenses incurred should it be sued in connection with the offerings. *De Laurentiis*, 124 B.R. at 306. PaineWebber was subsequently sued by securities holders on the theory that the prospectuses and SEC registration statements contained misstatements of fact. *Id.* at 306-07. PaineWebber claimed to have incurred over $ 800,000 in attorneys' fees in connection with defending itself in the suits, and asserted **[*828]** a contract-based claim for the litigation expenses against the debtor. *Id.* at 307. The debtor subsequently filed its plan of reorganization, which subordinated the PaineWebber litigation expense claims pursuant to § 510(b). *Id.* PaineWebber filed a motion to have its litigation expense claim classified as general unsecured claim, which the debtor and the creditors' committee opposed. *Id.* The bankruptcy court granted PaineWebber's motion and classified the claim as a general unsecured claim. *Id.* The committee and the debtor appealed. *Id.*

The *De Laurentiis* court first examined the language of § 510(b). The court, citing *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 103 L. Ed. 2d 290, 109 S. Ct. 1026 (1989), stated **[**37]** that in interpreting § 510(b), it must first look at the language to determine if, on its face, it has plain meaning. *De Laurentiis*, 124 B.R. at 307-08. If so, then the court's inquiry should end unless "'the literal application of a statute will produce a result demonstrably at odds with the intention of its drafters.'" *Id.* at 308 (quoting *Ron Pair*, 489 U.S. at 242). The court agreed with the committee's argument that PaineWebber's claim for litigation costs pursuant to its indemnification agreement was a claim for reimbursement under § 510(b) because "reimbursement by definition includes indemnification." *Id.* The court rejected PaineWebber's argument that § 510(b)'s language does not mandate subordination of litigation expense claims. PaineWebber stated that § 510(b) did not mention litigation expense claims and, thus, the language must by interpreted by ascertaining congressional intent. *Id.* It asserted that the 1984 amendment language supported the litigation expense/liability claim distinction drawn in *Christian Life*. *Id.* PaineWebber focused on the words "on account of" in § 510(b) as revealing Congress's intent to subordinate only those reimbursement **[**38]** or contribution claims which would be passed on to the equity holders asserting damage or rescission claims; if Congress had meant to include litigation expense claims, it would have used the words "associated with," "related to," or "arising out of" in the reimbursement clause. *Id.* Noting that Black's Law Dictionary defines "on account" to mean only "in part payment" or "in partial satisfaction," which did not have the limiting effect on which PaineWebber insisted, the court "declined to adopt the novel interpretation proposed by PaineWebber and interprets 'on account of' consistent with its meaning in normal usage." 124 B.R. at 308. The court then found that the plain language of § 510(b) included claims for indemnification of litigation expenses and, thus, the inquiry would continue only if PaineWebber could show "that subordination of an underwriter's claim for indemnification of attorneys' fees in this case is 'demonstrably at odds with the intention of its drafters' and not

within the intended scope of Section 510(b)." *Id.* (quoting *Ron Pair*, 489 U.S. at 242).

The court found that PaineWebber, despite presenting "strong policy reasons to support [its] position," **[**39]** failed to meet its burden of showing that subordination of its claim would subvert congressional intent. 124 B.R. at 309-10. The court then set forth three policy reasons supporting its plain reading conclusion.

The court noted that the fair allocation of risk between creditors and shareholders was an important policy consideration that the *Christian Life* court did not discuss. By allowing PaineWebber to recover as a general unsecured creditor, the court believed that it would be shifting the risks associated with the issuance of stock from the underwriter, who is in a better position to evaluate such risks, to the general unsecured creditors. *Id.* at 310. The legislative history discussed above clearly supports this position. See *supra* pp. 22-26.

The court listed two additional policy considerations supporting its conclusion. First, an attorneys' fees exception to § 510(b) could potentially apply to all attorneys' fees claims in securities litigation, and not just those of the defendants. *Id.* Second, the court stated that failure to subordinate attorneys' fees claims may eliminate incentives to settle securities cases because indemnity claims against the debtor will **[**40]** be subordinated while litigation costs incurred in continuing to defend the lawsuit will be subsidized by the unsecured creditors. In articulating this last policy consideration, it is clear that the court **[*829]** saw no basis to debate the issue of the underwriter's liability claim being subject to § 510(b):

> Additionally, the failure to subordinate attorneys' fees may eliminate an incentive to settle securities cases. The Committee highlights the fact that underwriters are not permitted to pass on their damage claims that result from litigation surrounding the issued securities. *If PaineWebber settles the case by agreeing to pay some damages, its indemnity claim against the debtor is subordinated.* However, under PaineWebber's theory, if PaineWebber continues to litigate, its litigation costs are subsidized by the unsecured creditors. Thus, PaineWebber's interpretation of the statute could act as a disincentive to settlement.

Id. at 310. (emphasis added)

Following *DeLaurentiis*, the court in *In re Public Serv. Co.*, 129 B.R. 3, 5 (Bankr. D.N.H. 1991) likewise found § 510(b) unambiguous and the claimants' arguments for a differing interpretation wanting. The court **[**41]** found that officers' and directors' reimbursement claims, both as to damages and attorneys' fees, are to be subordinated under § 510(b). *Id.* at 5.

In summary, I conclude that § 510(b) is unambiguous in requiring the subordination of Claimants' reimbursement claims, both for liability and expenses, resulting from securities law claims by purchasers or sellers of a debtor's securities. This conclusion is consistent with the legislative history and is supported by the reported decisions addressing the issue. NatWest's argument to the contrary about what Congress might have intended in 1984 is misconceived.

CONCLUSION

For the reasons set forth above, the O&D Claimants administrative expense priority claims are disallowed and the Claimants' claims are subordinated pursuant to § 510(b) and therefore will be treated as Class 7 claims in MAWS's Plan.

Counsel for MAWS should submit an order on notice.

TAB 13

In re JACOM COMPUTER SERVICES, INC. and UNICAPITAL CORPORATION, et al., Debtors.

Chapter 11, Case Nos. 00 B 42719 (CB) through 00 B 42837 (CB), (Jointly Administered)

UNITED STATES BANKRUPTCY COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

280 B.R. 570; 2002 Bankr. LEXIS 758; 48 Collier Bankr. Cas. 2d (MB) 758

July 23, 2002, Decided

SUBSEQUENT HISTORY: Subsequent appeal at Cauff v. Jacom Computer Servs. (In re Jacom Computer Servs.), 2006 U.S. Dist. LEXIS 53868 (S.D.N.Y., July 31, 2006)

DISPOSITION: **[**1]** Disbursing Agents' application to estimate claims number 295, 488 and 1132 at zero was granted.

CASE SUMMARY:

PROCEDURAL POSTURE: Chapter 11 plan's disbursing agent moved to estimate disputed claims so that he could establish an appropriate reserve. Claimant underwriters objected to the characterization of their claims as subordinated under 11 U.S.C.S. § 510(b), contending their claims were for indemnification of costs arising from a lawsuit filed against the underwriters and the debtors in connection with the debtor's stock offering.

OVERVIEW: The underwriters argued their claims arose from a contract with the debtors where the debtors agreed to indemnify and hold harmless the underwriters. The court held that indemnification claims of a debtor's underwriters for legal expenses incurred in defending an action brought by the debtor's shareholders, which also named the underwriters as defendants, for securities fraud, was subordinated under § 510(b). Section 510(b) subordinated the indemnification claims of officers, directors, and underwriters for both liability and expenses incurred in connection with the pursuit of claims for rescission or damages by purchasers or sellers of the debtor's securities. Congress made the decision to subordinate based on risk allocation. The inclusion of reimbursement and contribution claims to subordination under § 510(b) was simply the addition of new classes of persons and entities involved with the securities transactions giving rise to the rescission and damage claims. Reimbursement by definition included indemnification, which included attorneys' fees. The court was not persuaded by the underwriters' characterization of their claims as "indemnification" as opposed to "reimbursement."

OUTCOME: The disbursing agents' application to estimate the claims filed by the underwriters at zero was granted.

CORE TERMS: underwriters', indemnification, reimbursement, subordinated, rescission, indemnity, sale of securities, plain language, expenses incurred, characterization, shareholder, subordinate, estimate, claimants

LexisNexis(R) Headnotes

Bankruptcy Law > Claims > Allowance
Bankruptcy Law > Claims > Types > Unsecured Priority Claims > Subordination
Securities Law > Blue Sky Laws > Offer & Sale
[HN1] 11 U.S.C.S. § 510(b) deals with the subordination of claims arising from the purchase or sale of securities,

rescission of such a purchase or sale, or for reimbursement or contribution allowed under 11 U.S.C.S. § 502 on account of such a claim.

Bankruptcy Law > Claims > Allowance
Bankruptcy Law > Claims > Types > Unsecured Priority Claims > Subordination
[HN2] Indemnification claims of a debtor's underwriters for legal expenses incurred in a defense of an action commenced by the debtor's shareholders, which action names the underwriters as defendants, for, among other things, securities fraud, should be subordinated pursuant to the plain language of 11 U.S.C.S. § 510(b).

Bankruptcy Law > Claims > Allowance
Bankruptcy Law > Claims > Types > Unsecured Priority Claims > Subordination
Securities Law > Blue Sky Laws > Offer & Sale
[HN3] 11 U.S.C.S. § 510(b) intends to subordinate the indemnification claims of officers, directors, and underwriters for both liability and expenses incurred in connection with the pursuit of claims for rescission or damages by purchasers or sellers of the debtor's securities. It is readily apparent that the rationale for § 510(b) is not limited to preventing shareholder claimants from improving their positions vis-a-vis general creditors; Congress also made the decision to subordinate based on risk allocation. The inclusion of reimbursement and contribution claims to those subordinated under § 510(b) is simply the addition of new classes of persons and entities involved with the securities transactions giving rise to the rescission and damage claims.

Bankruptcy Law > Claims > Allowance
Bankruptcy Law > Claims > Types > Unsecured Priority Claims > Subordination
Contracts Law > Contract Conditions & Provisions > Indemnity
[HN4] Reimbursement, as used in 11 U.S.C.S. § 510(b), by definition includes indemnification, and indemnification naturally includes recovery of attorneys' fees.

COUNSEL: Cravath, Swaine & Moore, New York, New York, Evan R. Chesler, Esq., Daniel Slifkin, Esq., Of Counsel, for Morgan Stanley & Co., Inc., Salomon Smith Barney, and Friedman, Billings, Ramsey & Co.

Greenberg Traurig, New York, New York, Richard S. Miller, Esq., Robert T. Honeywell, Esq., Of Counsel, for Jacom Computer Services, Inc., UniCapital Corp., et al.

JUDGES: CORNELIUS BLACKSHEAR, UNITED STATES BANKRUPTCY JUDGE.

OPINION BY: CORNELIUS BLACKSHEAR

OPINION

[*571] DECISION REGARDING CLAIMS OF UNDERWRITERS

CORNELIUS BLACKSHEAR

UNITED STATES BANKRUPTCY JUDGE

In this confirmed chapter 11 case, the Disbursing Agent under the Plan, UniCapital Corporation, has moved to estimate certain disputed claims so that the Disbursing Agent may identify the universe of Class 5 General Unsecured Claims and establish an appropriate reserve. Claimants Morgan Stanley & Co., Inc., Cravath Swaine & Moore, and Friedman Billings Ramsey & Co., Inc., hereafter known as the Underwriters, have objected to the Debtor's application. Specifically, the Underwriters object to the Debtor's characterization of their claims **[**2]** as subordinated pursuant to 11 U.S.C. § 510(b). The Underwriters contend that their claim against the debtors is for indemnification of costs incurred by the Underwriters in connection with a class action lawsuit filed against the Underwriters and the debtors in connection with the initial public offering of the debtor's stock.

[HN1] Section 510(b) deals with the subordination of claims arising from the purchase or sale of securities, rescission of such a purchase or sale, or "for reimbursement or contribution allowed under section 502 on account of such a claim". The Debtors appear to argue that the Underwriters' claim is one "for reimbursement or contribution **[*572]** ...on account of" a claim arising from the purchase or sale of securities, and therefore must be subordinated pursuant to the plain language of the statute.

The Underwriters contend that claim arises from its contract with the debtor - the Underwriting Agreement dated May 14, 1998, annexed to the Proof of Claim of Salomon Smith Barney, Inc. This Court refers the parties to Section 7 "Indemnity and Contribution", where the debtors agreed to indemnify and hold harmless the Underwriters.

The issue presented by **[**3]** the Underwriters' motion appears to one of first impression in this Circuit. The parties have directed this Court to the few reported cases that discuss section 510(b). One case, *In re Christian Life Center*, 821 F.2d 1370, written by the Ninth Circuit, unfortunately deals with section 510(b) BEFORE it was amended in 1984 to include, *inter alia*, the language "for reimbursement or contribution allowed under section 502 on account of such a claim". The *Christian Life* case can therefore offer little if any guidance in interpreting the current statute.

Instead, this Court agrees with the analysis of *In re Mid-American Waste Systems, Inc.*, **228 B.R. 816, written in 1999 by Chief Bankruptcy Judge Walsh in Delaware. In that case, Judge Walsh found that the** [HN2] **indemnification claims of a debtor's underwriters for legal expenses incurred in defense of an action commenced by the debtor's shareholders, which action named the underwriters as defendants, for, among other things, securities fraud, should be subordinated pursuant to the plain language of section 510(b).**

> [HN3] **[Section] 510(b) intends to subordinate the indemnification claims of officers, [**4] directors, and underwriters for both liability and expenses incurred in connection with the pursuit of claims for rescission or damages by purchasers or sellers of the debtor's securities ... It is readily apparent that the rationale for section 510(b) is not limited to preventing shareholder claimants from improving their positions vis-a-vis general creditors; Congress also made the decision to subordinate based on risk allocation.**

In re Mid-American Waste Systems, Inc., **228 B.R. 816, 824-6 (Bankr. Del. 1999). The inclusion of reimbursement and contribution claims to those subordinated under section 510(b) is simply the addition of "new classes of persons and entities involved with the securities transactions giving rise to the rescission and damage claims."** *Id.* at 826. This Court agrees with Judge Walsh that the underwriters are in a better position to allocate risks associated with the issuance of securities and that it is inconsistent with the policies articulated in the legislative history of section 510(b) to force unsecured creditors to subsidize the underwriters' litigation costs. *See also In re Walnut Equipment Leasing Co., Inc.*, 1999 Bankr. LEXIS 1626, 1999 WL 1271762, **[**5]** at *11 (Bankr. E.D. Pa. 1999); *In re De Laurentiis Entertainment Group, Inc.*, 124 B.R. 305, 310 (C.D. Cal. 1991).

Finally, taking the Underwriters argument that their claim arises from their indemnity contract with the Debtors, this Court notes that the indemnity provision is a provision of the Underwriting Contract. Further, this Court agrees with the analysis outlined in the *De Laurentiis* case: [HN4] "reimbursement by definition includes indemnification, and indemnification naturally includes recovery of attorneys' fees." 124 B.R. at 308. This Court is not persuaded by Underwriters' characterization of their claim as one for "indemnification" as opposed to "reimbursement" (the term used in the statute).

[*573] The Disbursing Agents' application to estimate claims number 295, 488 and 1132 at zero is granted. The attorneys for the Disbursing Agents are directed to settle an order on five business days' notice consistent with this decision.

Dated: New York, New York

July 23, 2002

/s/ Cornelius Blackshear

United States Bankruptcy Judge

Tab 14

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 OR COMPROMISE OR ARRANGEMENT OF SINO-FOREST CORPORATION

Court File No. CV-12-9667-00CL

ONTARIO
SUPERIOR COURT OF JUSTICE
(COMMERCIAL LIST)

Proceedings commenced in Toronto

BOOK OF AUTHORITIES OF THE APPLICANT, SINO-FOREST CORPORATION
(Motion Regarding the Status of Shareholder Claims and Related Indemnity Claims under the CCAA, Returnable June 26, 2012)

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