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 AD HOC COMMITTEE OF NOTEHOLDERS OF SINO-FOREST CORPORATION

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"equity claim" *« réclamation relative à des capitaux propres »*

"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" *« intérêt relatif à des capitaux propres »*

"equity interest" means

(*a*) in the case of a company other than an income trust, a share in the company — or a warrant or option or another right to acquire a share in the company — 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;

"financial collateral" *« garantie financière »*

"financial collateral" means any of the following that is subject to an interest, or in the Province of Quebec a right, that secures payment or performance of an obligation in respect of an eligible financial contract or that is subject to a title transfer credit support agreement:

(*a*) cash or cash equivalents, including negotiable instruments and demand deposits,

(*b*) securities, a securities account, a securities entitlement or a right to acquire securities, or

(*c*) a futures agreement or a futures account;

"income trust" *« fiducie de revenu »*

"income trust" means a trust that has assets in Canada if

(*a*) its units are listed on a prescribed stock exchange on the day on which proceedings commence under this Act, or

(*b*) the majority of its units are held by a trust whose units are listed on a prescribed stock exchange on the day on which proceedings commence under this Act;

toutes les fins de la présente loi sauf la votation à une assemblée des créanciers relativement à ces obligations.

« créancier garanti » *"secured creditor"*

« créancier garanti » Détenteur d'hypothèque, de gage, charge, nantissement ou privilège sur ou contre l'ensemble ou une partie des biens d'une compagnie débitrice, ou tout transport, cession ou transfert de la totalité ou d'une partie de ces biens, à titre de garantie d'une dette de la compagnie débitrice, ou un détenteur de quelque obligation d'une compagnie débitrice garantie par hypothèque, gage, charge, nantissement ou privilège sur ou contre l'ensemble ou une partie des biens de la compagnie débitrice, ou un transport, une cession ou un transfert de tout ou partie de ces biens, ou une fiducie à leur égard, que ce détenteur ou bénéficiaire réside ou soit domicilié au Canada ou à l'étranger. Un fiduciaire en vertu de tout acte de fiducie ou autre instrument garantissant ces obligations est réputé un créancier garanti pour toutes les fins de la présente loi sauf la votation à une assemblée de créanciers relativement à ces obligations.

« demande initiale » *"initial application"*

« demande initiale » La demande faite pour la première fois en application de la présente loi relativement à une compagnie.

« état de l'évolution de l'encaisse » *"cash-flow statement"*

« état de l'évolution de l'encaisse » Relativement à une compagnie, l'état visé à l'alinéa 10(2)*a*) portant, projections à l'appui, sur l'évolution de l'encaisse de celle-ci.

« fiducie de revenu » *"income trust"*

« fiducie de revenu » Fiducie qui possède un actif au Canada et dont les parts sont inscrites à une bourse de valeurs mobilières visée par règlement à la date à laquelle des procédures sont intentées sous le régime de la présente loi, ou sont détenues en majorité par une fiducie dont les parts sont inscrites à une telle bourse à cette date.

« garantie financière » *"financial collateral"*

« garantie financière » S'il est assujetti soit à un intérêt ou, dans la province de Québec, à un droit garantissant le paiement d'une somme ou l'exécution d'une obligation relativement à un contrat financier admissible, soit à un accord de transfert de titres pour obtention de crédit, l'un ou l'autre des éléments suivants :

a) les sommes en espèces et les équivalents de trésorerie — notamment les effets négociables et dépôts à vue;

1985, if the prescribed plan were regulated by an Act of Parliament; and

(*b*) the court is satisfied that the company can and will make the payments as required under paragraph (*a*).

Non-application of subsection (6)

(7) Despite subsection (6), the court may sanction a compromise or arrangement that does not allow for the payment of the amounts referred to in that subsection if it is satisfied that the relevant parties have entered into an agreement, approved by the relevant pension regulator, respecting the payment of those amounts.

Payment — equity claims

(8) 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.

R.S., 1985, c. C-36, s. 6; 1992, c. 27, s. 90; 1996, c. 6, s. 167; 1997, c. 12, s. 123; 2004, c. 25, s. 194; 2005, c. 47, s. 126, 2007, c. 36, s. 106; 2009, c. 33, s. 27.

Court may give directions

7. Where an alteration or a modification of any compromise or arrangement is proposed at any time after the court has directed a meeting or meetings to be summoned, the meeting or meetings may be adjourned on such term as to notice and otherwise as the court may direct, and those directions may be given after as well as before adjournment of any meeting or meetings, and the court may in its discretion direct that it is not necessary to adjourn any meeting or to convene any further meeting of any class of creditors or shareholders that in the opinion of the court is not adversely affected by the alteration or modification proposed, and any compromise or arrangement so altered or modified may be sanctioned by the court and have effect under section 6.

R.S., c. C-25, s. 7.

Scope of Act

8. This Act extends and does not limit the provisions of any instrument now or hereafter existing that governs the rights of creditors or any class of them and has full force and effect notwithstanding anything to the contrary contained in that instrument.

R.S., c. C-25, s. 8.

Non-application du paragraphe (6)

(7) Par dérogation au paragraphe (6), le tribunal peut homologuer la transaction ou l'arrangement qui ne prévoit pas le versement des sommes mentionnées à ce paragraphe s'il est convaincu que les parties en cause ont conclu un accord sur les sommes à verser et que l'autorité administrative responsable du régime de pension a consenti à l'accord.

Paiement d'une réclamation relative à des capitaux propres

(8) Le tribunal ne peut homologuer la transaction ou l'arrangement qui prévoit le paiement d'une réclamation relative à des capitaux propres que si, selon les termes de celle-ci, le paiement intégral de toutes les autres réclamations sera effectué avant le paiement de la réclamation relative à des capitaux propres.

L.R. (1985), ch. C-36, art. 6; 1992, ch. 27, art. 90; 1996, ch. 6, art. 167; 1997, ch. 12, art. 123; 2004, ch. 25, art. 194; 2005, ch. 47, art. 126, 2007, ch. 36, art. 106; 2009, ch. 33, art. 27.

Le tribunal peut donner des instructions

7. Si une modification d'une transaction ou d'un arrangement est proposée après que le tribunal a ordonné qu'une ou plusieurs assemblées soient convoquées, cette ou ces assemblées peuvent être ajournées aux conditions que peut prescrire le tribunal quant à l'avis et autrement, et ces instructions peuvent être données tant après qu'avant l'ajournement de toute ou toutes assemblées, et le tribunal peut, à sa discrétion, prescrire qu'il ne sera pas nécessaire d'ajourner quelque assemblée ou de convoquer une nouvelle assemblée de toute catégorie de créanciers ou actionnaires qui, selon l'opinion du tribunal, n'est pas défavorablement atteinte par la modification proposée, et une transaction ou un arrangement ainsi modifié peut être homologué par le tribunal et être exécutoire en vertu de l'article 6.

S.R., ch. C-25, art. 7.

Champ d'application de la loi

8. La présente loi n'a pas pour effet de limiter mais d'étendre les stipulations de tout instrument actuellement ou désormais existant relativement aux droits de créanciers ou de toute catégorie de ces derniers, et elle est pleinement exécutoire et effective nonobstant toute stipulation contraire de cet instrument.

S.R., ch. C-25, art. 8.

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.

rangement, et la mesure dans laquelle il pourrait être satisfait à leurs réclamations s'ils s'en prévalaient;

d) tous autres critères réglementaires compatibles avec ceux énumérés aux alinéas *a*) à *c*).

Related creditors

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

1997, c. 12, s. 126; 2005, c. 47, s. 131; 2007, c. 36, s. 71.

Créancier lié

(3) Le créancier lié à la compagnie peut voter contre, mais non pour, l'acceptation de la transaction ou de l'arrangement.

1997, ch. 12, art. 126; 2005, ch. 47, art. 131; 2007, ch. 36, art. 71.

Class — creditors having equity claims

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.

2005, c. 47, s. 131; 2007, c. 36, s. 71.

Catégorie de créanciers ayant des réclamations relatives à des capitaux propres

22.1 Malgré le paragraphe 22(1), les créanciers qui ont des réclamations relatives à des capitaux propres font partie d'une même catégorie de créanciers relativement à ces réclamations, sauf ordonnance contraire du tribunal, et ne peuvent à ce titre voter à aucune assemblée, sauf ordonnance contraire du tribunal.

2005, ch. 47, art. 131; 2007, ch. 36, art. 71.

MONITORS

Duties and functions

23. (1) The monitor shall

(*a*) except as otherwise ordered by the court, when an order is made on the initial application in respect of a debtor company,

(i) publish, without delay after the order is made, once a week for two consecutive weeks, or as otherwise directed by the court, in one or more newspapers in Canada specified by the court, a notice containing the prescribed information, and

(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;

(*b*) review the company's cash-flow statement as to its reasonableness and file a report with the court on the monitor's findings;

CONTRÔLEURS

Attributions

23. (1) Le contrôleur est tenu :

a) à moins que le tribunal n'en ordonne autrement, lorsqu'il rend une ordonnance à l'égard de la demande initiale visant une compagnie débitrice :

(i) de publier, sans délai après le prononcé de l'ordonnance, une fois par semaine pendant deux semaines consécutives, ou selon les modalités qui y sont prévues, dans le journal ou les journaux au Canada qui y sont précisés, un avis contenant les renseignements réglementaires,

(ii) dans les cinq jours suivant la date du prononcé de l'ordonnance :

(A) de rendre l'ordonnance publique selon les modalités réglementaires,

(B) d'envoyer un avis, selon les modalités réglementaires, à chaque créancier connu ayant une réclamation supérieure à mille dollars les informant que l'ordonnance a été rendue publique,

(C) d'établir la liste des nom et adresse de chacun de ces créanciers et des montants estimés des réclamations et de la rendre publique selon les modalités réglementaires;

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"eligible financial contract" *« contrat financier admissible »*

"eligible financial contract" means an agreement of a prescribed kind;

"equity claim" *« réclamation relative à des capitaux propres »*

"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" *« intérêt relatif à des capitaux propres »*

"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;

"executing officer" *« huissier-exécutant »*

"executing officer" includes a sheriff, a bailiff and any officer charged with the execution of a writ or other process under this Act or any other Act or proceeding with respect to any property of a debtor;

"financial collateral" *« garantie financière »*

"financial collateral" means any of the following that is subject to an interest, or in the Province of Quebec a right, that secures payment or performance of an obligation in respect of an eligible financial contract or that is subject to a title transfer credit support agreement:

(*a*) cash or cash equivalents, including negotiable instruments and demand deposits,

(*b*) securities, a securities account, a securities entitlement or a right to acquire securities, or

de télécommunications, d'enlèvement des ordures ou de lutte contre la pollution ou encore des services postaux.

« failli » *"bankrupt"*

« failli » Personne qui a fait une cession ou contre laquelle a été rendue une ordonnance de faillite. Peut aussi s'entendre de la situation juridique d'une telle personne.

« faillite » *"bankruptcy"*

« faillite » L'état de faillite ou le fait de devenir en faillite.

« fiducie de revenu » *"income trust"*

« fiducie de revenu » Fiducie qui possède un actif au Canada et dont les parts sont inscrites à une bourse de valeurs mobilières visée par les Règles générales à la date de l'ouverture de la faillite, ou sont détenues en majorité par une fiducie dont les parts sont inscrites à une telle bourse à cette date.

« garantie financière » *"financial collateral"*

« garantie financière » S'il est assujetti soit à un intérêt ou, dans la province de Québec, à un droit garantissant le paiement d'une somme ou l'exécution d'une obligation relativement à un contrat financier admissible, soit à un accord de transfert de titres pour obtention de crédit, l'un ou l'autre des éléments suivants :

a) les sommes en espèces et les équivalents de trésorerie — notamment les effets négociables et dépôts à vue;

b) les titres, comptes de titres, droits intermédiés et droits d'acquérir des titres;

c) les contrats à terme ou comptes de contrats à terme.

« huissier-exécutant » *"sheriff"*

« huissier-exécutant » Shérif, huissier ou autre personne chargée de l'exécution d'un bref ou autre procédure sous l'autorité de la présente loi ou de toute autre loi, ou de toute autre procédure relative aux biens du débiteur.

« intérêt relatif à des capitaux propres » *"equity interest"*

« intérêt relatif à des capitaux propres »

a) S'agissant d'une personne morale autre qu'une fiducie de revenu, action de celle-ci ou bon de souscription, option ou autre droit permettant d'acquérir une telle action et ne provenant pas de la conversion d'une dette convertible;

b) s'agissant d'une fiducie de revenu, part de celle-ci ou bon de souscription, option ou autre droit permettant d'acquérir une telle part et ne provenant pas de la conversion d'une dette convertible.

Balance of claim

(3) A creditor whose rights are restricted by this section is entitled to rank as an unsecured creditor for any balance of claim due him.

R.S., 1985, c. B-3, s. 136; 1992, c. 1, s. 143(E), c. 27, s. 54; 1997, c. 12, s. 90; 2001, c. 4, s. 31; 2004, c. 25, s. 70; 2005, c. 47, s. 88.

Postponement of claims — creditor not at arm's length

137. (1) A creditor who, at any time before the bankruptcy of a debtor, entered into a transaction with the debtor and who was not at arm's length with the debtor at that time is not entitled to claim a dividend in respect of a claim arising out of that transaction until all claims of the other creditors have been satisfied, unless the transaction was in the opinion of the trustee or of the court a proper transaction.

(2) [Repealed, 2007, c. 36, s. 47]

R.S., 1985, c. B-3, s. 137; 2000, c. 12, s. 15; 2005, c. 47, s. 89; 2007, c. 36, s. 47.

138. [Repealed, 2007, c. 36, s. 48]

Postponement of claims of silent partners

139. Where a lender advances money to a borrower engaged or about to engage in trade or business under a contract with the borrower that the lender shall receive a rate of interest varying with the profits or shall receive a share of the profits arising from carrying on the trade or business, and the borrower subsequently becomes bankrupt, the lender of the money is not entitled to recover anything in respect of the loan until the claims of all other creditors of the borrower have been satisfied.

R.S., c. B-3, s. 110.

Postponement of wage claims of officers and directors

140. Where a corporation becomes bankrupt, no officer or director thereof is entitled to have his claim preferred as provided by section 136 in respect of wages, salary, commission or compensation for work done or services rendered to the corporation in any capacity.

R.S., c. B-3, s. 111.

Postponement of equity claims

140.1 A creditor is not entitled to a dividend in respect of an equity claim until all claims that are not equity claims have been satisfied.

2005, c. 47, s. 90; 2007, c. 36, s. 49.

Solde de réclamation

(3) Tout créancier dont le présent article restreint les droits prend rang comme créancier non garanti, quant à tout solde de réclamation qui lui est dû.

L.R. (1985), ch. B-3, art. 136; 1992, ch. 1, art. 143(A), ch. 27, art. 54; 1997, ch. 12, art. 90; 2001, ch. 4, art. 31; 2004, ch. 25, art. 70; 2005, ch. 47, art. 88.

Ajournement de réclamations relatives à des transactions

137. (1) Le créancier qui, avant la faillite du débiteur, a conclu une transaction avec celui-ci alors qu'il existait un lien de dépendance entre eux n'a pas droit de réclamer un dividende relativement à une réclamation née de cette transaction jusqu'à ce que toutes les réclamations des autres créanciers aient été satisfaites, sauf si la transaction était, de l'avis du syndic ou du tribunal, une transaction régulière.

(2) [Abrogé, 2007, ch. 36, art. 47]

L.R. (1985), ch. B-3, art. 137; 2000, ch. 12, art. 15; 2005, ch. 47, art. 89; 2007, ch. 36, art. 47.

138. [Abrogé, 2007, ch. 36, art. 48]

Renvoi des réclamations d'un bailleur de fonds

139. Lorsqu'un prêteur avance de l'argent à un emprunteur, engagé ou sur le point de s'engager dans un commerce ou une entreprise, aux termes d'un contrat, passé avec l'emprunteur, en vertu duquel le prêteur doit recevoir un taux d'intérêt variant selon les profits ou recevoir une partie des profits provenant de la conduite du commerce ou de l'entreprise, et que subséquemment l'emprunteur devient failli, le prêteur n'a droit à aucun recouvrement du chef d'un pareil prêt jusqu'à ce que les réclamations de tous les autres créanciers de l'emprunteur aient été acquittées.

S.R., ch. B-3, art. 110.

Renvoi des réclamations pour gages des dirigeants et administrateurs

140. Dans le cas où une personne morale devient en faillite, aucun dirigeant ou administrateur de celle-ci n'a droit à la priorité de réclamation prévue par l'article 136 à l'égard de tout salaire, traitement, commission ou rémunération pour travail exécuté ou services rendus à cette personne morale à quelque titre que ce soit.

S.R., ch. B-3, art. 111.

Réclamations relatives à des capitaux propres

140.1 Le créancier qui a une réclamation relative à des capitaux propres n'a pas droit à un dividende à cet égard avant que toutes les réclamations qui ne sont pas des réclamations relatives à des capitaux propres aient été satisfaites.

2005, ch. 47, art. 90; 2007, ch. 36, art. 49.

lishes a "provincial pension plan" as defined in that subsection.

instituant un régime général de pensions » au sens du paragraphe 3(1) de cette loi et si la loi provinciale institue un « régime provincial de pensions » au sens de ce paragraphe.

Where no quorum in a class

(2.2) Where there is no quorum of secured creditors in respect of a particular class of secured claims, the secured creditors having claims of that class shall be deemed to have voted for the refusal of the proposal.

Absence de quorum

(2.2) À défaut de quorum des créanciers garantis dans le cas d'une des catégories de créances garanties, les créanciers garantis qui possèdent une réclamation appartenant à cette catégorie sont réputés avoir voté en faveur du rejet de la proposition.

Related creditor

(3) A creditor who is related to the debtor may vote against but not for the acceptance of the proposal.

Créancier lié

(3) Un créancier qui est lié au débiteur peut voter contre, mais non pour, l'acceptation de la proposition.

Voting by trustee

(4) The trustee, as a creditor, may not vote on the proposal.

R.S., 1985, c. B-3, s. 54; 1992, c. 27, s. 22; 2000, c. 30, s. 143; 2007, c. 36, s. 19; 2009, c. 33, s. 21.

Vote par le syndic

(4) Le syndic, en tant que créancier, ne peut voter sur la proposition.

L.R. (1985), ch. B-3, art. 54; 1992, ch. 27, art. 22; 2000, ch. 30, art. 143; 2007, ch. 36, art. 19; 2009, ch. 33, art. 21.

Class — creditors having equity claims

54.1 Despite paragraphs 54(2)(*a*) and (*b*), 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.

2007, c. 36, s. 20.

Catégorie de créanciers ayant des réclamations relatives à des capitaux propres

54.1 Malgré les alinéas 54(2)*a*) et *b*), les créanciers qui ont des réclamations relatives à des capitaux propres font partie d'une même catégorie de créanciers relativement à ces réclamations, sauf ordonnance contraire du tribunal, et ne peuvent à ce titre voter à aucune assemblée, sauf ordonnance contraire du tribunal.

2007, ch. 36, art. 20.

Creditors may provide for supervision of debtor's affairs

55. At a meeting to consider a proposal, the creditors, with the consent of the debtor, may include such provisions or terms in the proposal with respect to the supervision of the affairs of the debtor as they may deem advisable.

R.S., c. B-3, s. 37.

Les créanciers peuvent assurer la surveillance des affaires du débiteur

55. À une assemblée convoquée pour étudier une proposition, les créanciers, avec l'approbation du débiteur, peuvent inclure, dans la proposition, les dispositions ou les conditions qui peuvent être jugées convenables relativement à la surveillance des affaires du débiteur.

S.R., ch. B-3, art. 37.

Appointment of inspectors

56. The creditors may appoint one or more, but not exceeding five, inspectors of the estate of the debtor, who shall have the powers of an inspector under this Act, subject to any extension or restriction of those powers by the terms of the proposal.

R.S., c. B-3, s. 38.

Nomination d'inspecteurs

56. Les créanciers peuvent nommer un ou plusieurs, mais au plus cinq, inspecteurs de l'actif du débiteur, qui possèdent les pouvoirs d'un inspecteur aux termes de la présente loi, sous réserve toutefois de l'extension ou de la restriction de ces pouvoirs que prévoit la proposition.

S.R., ch. B-3, art. 38.

Result of refusal of proposal

57. Where the creditors refuse a proposal in respect of an insolvent person,

(*a*) the insolvent person is deemed to have thereupon made an assignment;

(*b*) the trustee shall, without delay, file with the official receiver, in the prescribed form, a report of the deemed assignment;

Effet du rejet d'une proposition

57. Lorsque les créanciers refusent d'accepter une proposition visant une personne insolvable :

a) celle-ci est réputée avoir fait dès lors une cession;

b) le syndic en fait immédiatement rapport, en la forme prescrite, au séquestre officiel;

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*** Current through PL 112-106, approved 4/5/12 ***

TITLE 11. BANKRUPTCY
CHAPTER 5. CREDITORS, THE DEBTOR, AND THE ESTATE
SUBCHAPTER I. CREDITORS AND CLAIMS

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11 USCS § 510

§ 510. Subordination

(a) A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law.

(b) 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 [11 USCS § 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.

(c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may--
(1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or
(2) order that any lien securing such a subordinated claim be transferred to the estate.

HISTORY:
(Nov. 6, 1978, P.L. 95-598, Title I, § 101, 92 Stat. 2586; July 10, 1984, P.L. 98-353, Title III, Subtitle H, § 451, 98 Stat. 375.)

HISTORY; ANCILLARY LAWS AND DIRECTIVES

Prior law and revision:
Legislative Statements
Section 510(c)(1) of the House amendment represents a compromise between similar provisions in the House bill and Senate amendment. After notice and a hearing, the court may, under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest. As a matter of equity, it is reasonable that a court subordinate claims to claims and interests to interests. It is intended that the term "principles of equitable subordination" follow existing case law and leave to the courts development of this principle. To date, under existing law, a claim is generally

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TITLE 11. BANKRUPTCY
CHAPTER 5. CREDITORS, THE DEBTOR, AND THE ESTATE
SUBCHAPTER I. CREDITORS AND CLAIMS

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11 USCS § 502

§ 502. Allowance of claims or interests

(a) A claim or interest, proof of which is filed under section 501 of this title [11 USCS § 501], is deemed allowed, unless a party in interest, including a creditor of a general partner in a partnership that is a debtor in a case under chapter 7 of this title [11 USCS §§ 701 et seq.], objects.

(b) Except as provided in subsections (e)(2), (f), (g), (h) and (i) of this section, if such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount, except to the extent that--
(1) such claim is unenforceable against the debtor and property of the debtor, under any agreement or applicable law for a reason other than because such claim is contingent or unmatured;
(2) such claim is for unmatured interest;
(3) if such claim is for a tax assessed against property of the estate, such claim exceeds the value of the interest of the estate in such property;
(4) if such claim is for services of an insider or attorney of the debtor, such claim exceeds the reasonable value of such services;
(5) such claim is for a debt that is unmatured on the date of the filing of the petition and that is excepted from discharge under section 523(a)(5) of this title [11 USCS § 523(a)(5)];
(6) if such claim is the claim of a lessor for damages resulting from the termination of a lease of real property, such claim exceeds--
(A) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease, following the earlier of--
(i) the date of the filing of the petition; and
(ii) the date on which such lessor repossessed or the lessee surrendered, the leased property; plus
(B) any unpaid rent due under such lease, without acceleration, on the earlier of such dates;
(7) if such claim is the claim of an employee for damages resulting from the termination of an employment contract, such claim exceeds--
(A) the compensation provided by such contract, without acceleration, for one year following the earlier of--
(i) the date of the filing of the petition; or
(ii) the date on which the employer directed the employee to terminate, or such employee terminated, performance under such contract; plus
(B) any unpaid compensation due under such contract, without acceleration, on the earlier of such dates;

(8) such claim results from a reduction, due to late payment, in the amount of an otherwise applicable credit available to the debtor in connection with an employment tax on wages, salaries, or commissions earned from the debtor; or

(9) proof of such claim is not timely filed, except to the extent tardily filed as permitted under paragraph (1), (2), or (3) of section 726(a) of this title [11 USCS § 726(a)] or under the Federal Rules of Bankruptcy Procedure, except that a claim of a governmental unit shall be timely filed if it is filed before 180 days after the date of the order for relief or such later time as the Federal Rules of Bankruptcy Procedure may provide, and except that in a case under chapter 13 [11 USCS §§ 1301 et seq.], a claim of a governmental unit for a tax with respect to a return filed under section 1308 [11 USCS § 1308] shall be timely if the claim is filed on or before the date that is 60 days after the date on which such return was filed as required.

(c) 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; or

(2) any right to payment arising from a right to an equitable remedy for breach of performance.

(d) Notwithstanding subsections (a) and (b) of this section, the court shall disallow any claim of any entity from which property is recoverable under section 542, 543, 550, or 553 of this title [11 USCS § 542, 543, 550, or 553] or that is a transferee of a transfer avoidable under section 522(f), 522(h), 544, 545, 547, 548, 549, or 724(a) of this title [11 USCS § 522(f), 522(h), 544, 545, 547, 548, 549, or 724(a)], unless such entity or transferee has paid the amount, or turned over any such property, for which such entity or transferee is liable under section 522(i), 542, 543, 550, or 553 of this title [11 USCS § 522(i), 542, 543, 550, or 553].

(e) (1) Notwithstanding subsections (a), (b) and (c) of this section and paragraph (2) of this subsection, 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--

(A) such creditor's claim against the estate is disallowed;

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

(C) such entity asserts a right of subrogation to the rights of such creditor under section 509 of this title [11 USCS § 509].

(2) A claim for reimbursement or contribution of such an entity 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.

(f) In an involuntary case, a claim arising in the ordinary course of the debtor's business or financial affairs after the commencement of the case but before the earlier of the appointment of a trustee and the order for relief shall be determined as of the date such claim arises, and shall be allowed under subsection (a), (b), or (c) of this section or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition.

(g) (1) A claim arising from the rejection, under section 365 of this title [11 USCS § 365] or under a plan under chapter 9, 11, 12, or 13 of this title [11 USCS §§ 901 et seq., 1101 et seq., 1201 et seq., or 1301 et seq.], of an executory contract or unexpired lease of the debtor that has not been assumed shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition.

(2) A claim for damages calculated in accordance with section 562 [11 USCS § 562] shall be allowed under subsection (a), (b), or (c), or disallowed under subsection (d) or (e), as if such claim had arisen before the date of the filing of the petition.

(h) A claim arising from the recovery of property under section 522, 550, or 553 of this title [11 USCS § 522, 550, or 553] shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section, or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition.

(i) A claim that does not arise until after the commencement of the case for a tax entitled to priority under section 507(a)(8) of this title [11 USCS § 507(a)(8)] shall be determined, and shall be allowed under subsection (a), (b), or (c)

of this section, or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition.

(j) A claim that has been allowed or disallowed may be reconsidered for cause. A reconsidered claim may be allowed or disallowed according to the equities of the case. Reconsideration of a claim under this subsection does not affect the validity of any payment or transfer from the estate made to a holder of an allowed claim on account of such allowed claim that is not reconsidered, but if a reconsidered claim is allowed and is of the same class as such holder's claim, such holder may not receive any additional payment or transfer from the estate on account of such holder's allowed claim until the holder of such reconsidered and allowed claim receives payment on account of such claim proportionate in value to that already received by such other holder. This subsection does not alter or modify the trustee's right to recover from a creditor any excess payment or transfer made to such creditor.

(k) (1) The court, on the motion of the debtor and after a hearing, may reduce a claim filed under this section based in whole on an unsecured consumer debt by not more than 20 percent of the claim, if--

(A) the claim was filed by a creditor who unreasonably refused to negotiate a reasonable alternative repayment schedule proposed on behalf of the debtor by an approved nonprofit budget and credit counseling agency described in section 111 [11 USCS § 111];

(B) the offer of the debtor under subparagraph (A)--

(i) was made at least 60 days before the date of the filing of the petition; and

(ii) provided for payment of at least 60 percent of the amount of the debt over a period not to exceed the repayment period of the loan, or a reasonable extension thereof; and

(C) no part of the debt under the alternative repayment schedule is nondischargeable.

(2) The debtor shall have the burden of proving, by clear and convincing evidence, that--

(A) the creditor unreasonably refused to consider the debtor's proposal; and

(B) the proposed alternative repayment schedule was made prior to expiration of the 60-day period specified in paragraph (1)(B)(i).

HISTORY:

(Nov. 6, 1978, P.L. 95-598, Title I, § 101, 92 Stat. 2579; July 10, 1984, P.L. 98-353, Title III, Subtitle H, § 445, 98 Stat. 373; Oct. 27, 1986, P.L. 99-554, Title II, Subtitle C, §§ 257(j), 283(f), 100 Stat. 3115, 3117; Oct. 22, 1994, P.L. 103-394, Title II, § 213(a), Title III, § 304(h)(1), 108 Stat. 4125, 4134; April 20, 2005, P.L. 109-8, Title II, Subtitle A, § 201(a), Title VII, § 716(d), Title IX, § 910(b), 119 Stat. 42, 130, 184.)

HISTORY; ANCILLARY LAWS AND DIRECTIVES

Prior law and revision:

Legislative Statements

The House amendment adopts a compromise position in section 502(a) between H.R. 8200, as passed by the House, and the Senate amendment. Section 502(a) has been modified to make clear that a party in interest includes a creditor of a partner in a partnership that is a debtor under chapter 7. Since the trustee of the partnership is given an absolute claim against the estate of each general partner under section 723(c), creditors of the partner must have standing to object to claims against the partnership at the partnership level because no opportunity will be afforded at the partner's level for such objection.

The House amendment contains a provision in section 502(b)(1) that requires disallowance of a claim to the extent that such claim is unenforceable against the debtor and unenforceable against property of the debtor. This is intended to result in the disallowance of any claim for deficiency by an undersecured creditor on a non-recourse loan or under a State antideficiency law, special provision for which is made in section 1111, since neither the debtor personally, nor the property of the debtor is liable for such a deficiency. Similarly claims for usurious interest or which could be barred by an agreement between the creditor and the debtor would be disallowed.

Section 502(b)(7)(A) represents a compromise between the House bill and the Senate amendment. The House amendment takes the provision in H.R. 8200 as passed by the House of Representatives but increases the percentage from 10 to 15 percent.

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

Nelson Financial Group Ltd., Re

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

Ontario Superior Court of Justice [Commercial List]

Pepall J.

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

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

J.H. Grout, S. Aggarwal for Monitor

Pamela Foy for Ontario Securities Commission

Frank Lamie for Nelson Financial Group Ltd.

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

Michael Beardsley, Respondent for himself

Clifford Holland, Respondent for himself

Arnold Bolliger, Respondent for himself

John McVey, Respondent for himself

Joan Frederick, Respondent for herself

Rakesh Sharma, Respondent for himself

Larry Debono, Respondent for himself

Keith McClear, Respondent for himself

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Subject: Corporate and Commercial; Insolvency

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

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

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

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

Cases considered by *Pepall J.*:

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

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

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followed

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

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

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

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

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

Statutes considered:

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

s. 2 — considered

s. 2 "creditor" — considered

s. 121(1) — considered

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

Generally — referred to

s. 23(3) — referred to

s. 248 — referred to

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

Generally — referred to

s. 2 — referred to

s. 2(1) "claim" — considered

s. 2(1) "equity claim" — considered

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

s. 6(8) — considered

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

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

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Generally — referred to

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

***Pepall J.*:**

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

Background Facts

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

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

(a) Noteholders

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

(b) Preferred Shareholders

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

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

7 As of the *CCAA* filing date of March 23, 2010, Nelson had issued and outstanding 585,916.6 Series A and Series B preferred shares with an aggregate stated capital of $14,647,914. The preferred shares are held by ap-

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proximately 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 dir-

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ectors of those corporations committed breaches of the *Ontario Securities Act* in the course of selling preferred shares. The allegations include noncompliance with the prospectus requirements, the sale of shares in reliance upon exemptions that were inapplicable, the sale of shares to persons who were not accredited investors, and fraudulent and negligent misrepresentations made in the course of the sale of shares. The OSC hearing has been scheduled for the end of February, 2011.

(e) Legal Opinion

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

(f) Development of Plan

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

Motion

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

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

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

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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 res-

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cission, or, in Quebec, the annulment, of a purchase or sale of an equity interest, or

(e) contribution or indemnity in respect of a claim referred to in any of paragraphs (a) to (d);"

"Equity Interest" means

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

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

Section 6(8) states:

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

Section 22.1 states:

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

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

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

All debts and liabilities, present or future, to which the bankrupt is subject on the day on which the bankrupt becomes bankrupt or to which the bankrupt may become subject before the bankrupt's discharge by reason of any obligation incurred before the day on which the bankrupt becomes bankrupt shall be deemed to be claims provable in proceedings under this Act.

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

26 This treatment also has been held to encompass fraudulent misrepresentation claims advanced by a shareholder seeking to recover his investment: *Blue Range Resource Corp., Re*[FN3] In that case, Romaine J. held that the alleged loss derived from and was inextricably intertwined with the shareholder interest. Similarly,

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in the United States, the Second Circuit Court of Appeal in *Matter of Stirling Homex Corp.*[FN4] concluded that shareholders, including those who had allegedly been defrauded, were subordinate to the general creditors when the company was insolvent. The Court stated that "the real party against which [the shareholders] are seeking relief is the body of general creditors of their corporation. Whatever relief may be granted to them in this case will reduce the percentage which the general creditors will ultimately realize upon their claims." *National Bank of Canada v. Merit Energy Ltd.*[FN5] and *EarthFirst Canada Inc., Re*[FN6] both treated claims relating to agreements that were collateral to equity claims as equity claims. These cases dealt with separate indemnification agreements and the issuance of flow through shares. The separate agreements and the ensuing claims were treated as part of one integrated transaction in respect of an equity interest. The case law has also recognized the complications and delay that would ensue if *CCAA* proceedings were mired in shareholder claims.

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

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

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

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

31 In this 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

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shareholders ranked ahead of common shareholders. As in *Central Capital Corp.*, 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 Ltd., Re*[FN8], there is support in the case law for the proposition that equity may become debt. For instance, in that case, I held that a judgment obtained at the suit of a shareholder constituted debt. An analysis of the nature of the 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 fol- lowing:

(a) declared but unpaid dividends;

(b) unperformed requests for redemption;

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

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

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

35 There are two possible exceptions. Mr. McVey claims that his promissory note should never have been converted into preference shares, the conversion was unauthorized and that the signatures on the term sheets are not his own. If Mr. McVey's evidence is accepted, his claim would be qua creditor and not preferred shareholder. Secondly, it is possible that monthly dividends that may have been lent to Nelson by Larry Debono constitute

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debt claims. The factual record on these two possible exceptions is incomplete. The Monitor is to investigate both scenarios, consider a resolution of same, and report back to the court on notice to any affected parties.

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

Motion granted.

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

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

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

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

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

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

FN7 Supra, note 2.

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

FN9 Supra, note 5.

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

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2011 CarswellOnt 8590, 2011 ONSC 5018, 206 A.C.W.S. (3d) 464, 83 C.B.R. (5th) 123

Return on Innovation Capital Ltd. v. Gandi Innovations Ltd.

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)

Ontario Superior Court of Justice [Commercial List]

Newbould J.

Heard: August 18, 2011
Judgment: August 25, 2011[FN*]
Docket: 09-CL-8172

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Counsel: Harvey Chaiton, Maya Poliak for Monitor, BDO Canada Limited

Mathew Halpin, Evan Cobb for TA Associates Inc.

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

Subject: Corporate and Commercial; Insolvency

Business associations --- Specific matters of corporate organization — Directors and officers — Duty to manage — Indemnification by corporation

GG was group of companies under protection pursuant to Companies' Creditors Arrangement Act — GH LLC was parent of other companies in GG — Creditors were officers and board members of GH LLC — T Inc. invested in GG by way of debt and equity — T Inc. brought arbitration proceedings against creditors for recovery of its investment in GG — Creditors filed proof of claim against GG based on indemnity provisions — Creditors claimed they were entitled to indemnification by GG in respect of any damages award made against them in arbitration — Creditors disputed monitor's disallowance of indemnity claims — Monitor brought motion for advice and directions relating to creditors' indemnity claims — Motion was granted — Only indemnity given in favour of creditors was by GH LLC — GH LLC provided indemnity for board members and officers in its corporate documentation — Creditors were officers and board members of GH LLC — G Ltd. provided indemnity for directors and officers in its corporate documentation, but only one creditor was found to be director and officer — That creditor would not receive any payment from G Ltd. based on agreement subordinating his claims

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against G Ltd. to claims of T Inc., and amounts owing to T Inc. — Other companies in GG did not provide indemnity to creditors in corporate documentation or agreement — GG did not acknowledge liability to indemnify creditors — Monitor did not knowingly approve payment of creditors' defence costs of arbitration.

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

Equity claims — GG was group of companies under protection pursuant to Companies' Creditors Arrangement Act (CCAA) — GH LLC was parent of other companies in GG — Creditors were officers and board members of GH LLC — T Inc. invested in GG by way of debt and equity — T Inc. brought arbitration proceedings against creditors for recovery of its investment in GG — Creditors filed proof of claim against GG based on indemnity provisions — Creditors claimed they were entitled to indemnification by GG in respect of any damages award made against them in arbitration — Creditors disputed monitor's disallowance of indemnity claims — Monitor brought motion for advice and directions relating to creditors' indemnity claims — Motion was granted — Creditors' claims, as equity claims, were not to be paid until all other claims were paid in full, pursuant to s. 6(8) of CCAA — T Inc.'s claims in arbitration were equity claims, so creditors' claims for indemnity against those claims in CCAA process were also equity claims — T Inc. brought claims against creditors for breach of contract, fraud, rescission, negligent misrepresentation, breach of fiduciary duty, for purpose of recovering its investment made in GH LLC — Fact that T Inc.'s claim was based on those causes of action did not make it any less of claim in equity because T Inc. was seeking return of its equity investment.

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

Equity claims — GG was group of companies under protection pursuant to Companies' Creditors Arrangement Act (CCAA) — GH LLC was parent of other companies in GG — Creditors were officers and board members of GH LLC — T Inc. invested in GG by way of debt and equity — T Inc. brought arbitration proceedings against creditors for recovery of its investment in GG — Creditors filed proof of claim against GG based on indemnity provisions — Creditors claimed they were entitled to indemnification by GG in respect of any damages award made against them in arbitration — Creditors disputed monitor's disallowance of indemnity claims — Monitor brought motion for advice and directions relating to creditors' indemnity claims — Motion was granted — Creditors' claims, as equity claims, were not to be paid until all other claims were paid in full, pursuant to s. 6(8) of CCAA — T Inc.'s claims in arbitration were equity claims, so creditors' claims for indemnity against those claims in CCAA process were also equity claims — T Inc. brought claims against creditors for breach of contract, fraud, rescission, negligent misrepresentation, breach of fiduciary duty, for purpose of recovering its investment made in GH LLC — Fact that T Inc.'s claim was based on those causes of action did not make it any less of claim in equity because T Inc. was seeking return of its equity investment.

Cases considered by *Newbould J.*:

Nelson Financial Group Ltd., Re (2010), 71 C.B.R. (5th) 153, 75 B.L.R. (4th) 302, 2010 ONSC 6229, 2010 CarswellOnt 8655 (Ont. S.C.J. [Commercial List]) — considered

Statutes considered:

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

Generally — referred to

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s. 2(1) "equity claim" — referred to

s. 6(8) — considered

MOTION by monitor for advice and directions in connection with indemnity claims made by creditors.

***Newbould J.*:**

1 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

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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.

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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

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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

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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 $25million 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

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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

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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.

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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 *Nelson Financial Group Ltd., Re* (2010), 75 B.L.R. (4th) 302 (Ont. S.C.J. [Commercial List]), 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.

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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, recissory 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 *Nelson Financial Group Ltd., Re, 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.* 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.

Order accordingly.

FN* Additional reasons at *Return on Innovation Capital Ltd. v. Gandi Innovations Ltd.* (2011), 2011 CarswellOnt 14401, 2011 ONSC 7465 (Ont. S.C.J. [Commercial List]).

END OF DOCUMENT

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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/Respondents, and Gandi Innovations Limited, Gandi Innovations Holdings LLC and Gandi Innovations LLC, Respondents/Appellants

[2012] O.J. No. 31

2012 ONCA 10

Docket: M40553

Ontario Court of Appeal
Toronto, Ontario

R.J. Sharpe, R.A. Blair and P.S. Rouleau JJ.A.

Heard: January 3, 2012 by written submissions.
Judgment: January 9, 2012.

(13 paras.)

Bankruptcy and insolvency law -- Companies' Creditors Arrangement Act (CCAA) matters -- Compromises and arrangements -- Claims -- Claims against directors -- Motion by officers, directors and shareholders in Gandi Group for leave to appeal from order determining their entitlement to indemnity from Gandi Group companies arising out of arbitration proceedings brought against them by TA Associates dismissed -- TA Associates was major unsecured creditor in CCAA proceedings -- Issues raised by appeal were of no significance to practice -- Further, appeal with respect to these issues had little merit.

Motion by the officers, directors and shareholders in the Gandi Group for leave to appeal from an order determining their entitlement to indemnity from the Gandi Group companies arising out of arbitration proceedings brought against them by TA Associates, the major unsecured creditor in the CCAA proceedings. The Gandi Group companies were under CCAA protection. The order provided that the claimants were only entitled to indemnity from the direct and indirect parent company, that any claim of James Gandy was subordinated to the claim of TA Associates because of an earlier existing Subordination Agreement, and that the claims for indemnification in respect of the TA Associates claim in the arbitration were equity claims for purposes of the CCAA and therefore subsequent in priority to the claims of unsecured creditors.

HELD: Motion dismissed. The indemnification issue and subordination issues raised by the appeal were of no significance to the practice and the appeal with respect to these issues had little merit. The application judge's determination of the claimants' indemnity claims as equity claims was also not of significance to the practice since all insolvency proceedings commenced after the new provisions of the CCAA came into effect in September 2009 would be governed by those provisions, not by the prior jurisprudence.

Statutes, Regulations and Rules Cited:

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

Counsel:

Christopher J. Cosgriffe and Natasha S. Danson, for James Gandy, Hary Gandy and Trent Garmoe.

Matthew J. Halpin and Evan Cobb, for TA Associates Inc.

Harvey Chaiton and Maya Poliak, for the Monitor.

ENDORSEMENT

The following judgment was delivered by

THE COURT:--

Overview

1 The moving parties (James Gandy, Hary Gandy and Trent Garmoe) are officers, directors and shareholders in the Gandi Group, a series of related companies currently under CCAA protection. In those proceedings they assert indemnity claims in the range of $75 - 80 million against each of the companies in the Gandi Group. The indemnity claims arise out of arbitration proceedings brought against them individually, as officers and directors, by TA Associates, a disgruntled investor in the Gandi Group. TA Associates is the major unsecured creditor in the CCAA proceedings.

2 The assets of the Gandi Group have been sold and what remains to be done in the CCAA process is the finalization of a plan of compromise and arrangement for the distribution of the proceeds among the various creditors. Before settling on the most effective type of plan for such a distribution - a consolidated plan, a partial consolidation plan, or individual corporate plans - the Monitor and the creditors sought to have two preliminary issues determined by the Court:

a) whether the moving parties (the Claimants) are entitled to indemnity from all of the entities which comprise the Gandi Group, and, if so,

b) whether those indemnification claims are "equity" or "non-equity" claims for purposes of the CCAA (non-equity claims have priority).

3 On August 25, 2011, Justice Newbould, sitting on the Commercial List, ruled:

a) that the Claimants were only entitled to indemnity from the direct and indirect

parent company, Gandi Holdings (except that the Claimant, James Gandy only was also entitled to indemnification from a second entity in the Group, Gandi Canada);

b) that any claim of James Gandy was subordinated to the claim of TA Associates because of an earlier existing Subordination Agreement; and

c) that the claims for indemnification in respect of the TA Associates claim in the arbitration were equity claims for purposes of the CCAA and therefore subsequent in priority to the claims of unsecured creditors.

4 The Claimants seek leave to appeal from that order.

5 We deny the request.

Analysis

The Test

6 Leave to appeal is granted sparingly in CCAA proceedings and only when there are serious and arguable grounds that are of real and significant interest to the parties. The Court considers four factors:

(1) Whether the point on the proposed appeal is of significance to the practice;
(2) Whether the point is of significance to the action;
(3) Whether the appeal is prima facie meritorious or frivolous; and
(4) Whether the appeal will unduly hinder the progress of the action.

See *Re Stelco (Re)*, (2005), 75 O.R. (3d) 5, at para. 24 (C.A.).

7 The Claimants do not meet this stringent test here.

The Indemnification Issue

8 Whether the Claimants are entitled to indemnification from all or just one or some of the entities in the Gandi Group was essentially a factual determination by the motion judge, is of no significance to the practice as a whole, and the proposed appeal on that issue is of doubtful merit in our view. We would not grant leave to appeal on that issue.

The Subordination Issue

9 The same may be said for the Subordination Agreement issue. The Claimants argue that by declaring that the indemnity claim of James Gandy is subordinate to the CCAA claim of TA Associates, the motion judge usurped the role of the pending arbitration. We do not agree. The subordination issue needed to be clarified for purposes of the CCAA proceedings. None of the criteria respecting the granting of leave is met in relation to this proposed ground.

The "Equity Claim" Issue

10 Nor do we see any basis for granting leave to appeal on the equity/non-equity claim issue.

11 "Equity" claims are subsequent in priority to non-equity claims by virtue of s. 6(8) of the CCAA. What constitutes an "equity claim" is defined in s. 2(1) and would appear to encompass the indemnity claims asserted by the Claimants here. Those provisions of the Act did not come into force until shortly after the Gandi Group CCAA proceedings commenced, however, and therefore do not apply in this

situation. Newbould J. relied upon previous case law suggesting that the new provisions simply incorporated the historical treatment of equity claims in such proceedings: see, for example, *Re Nelson Financial Group Ltd.*, 2010 ONSC 6229 (CanLII), (2010), 75 B.L.R. (4th) 302, at para. 27 (Pepall J.). He therefore concluded that TA Associates was in substance attempting to reclaim its equity investment in the Gandi Group through the arbitration proceedings and that the Claimants' indemnity claims arising from that claim must be equity claims for CCAA purposes as well.

12 This issue in the proposed appeal is not of significance to the practice since all insolvency proceedings commenced after the new provisions of the CCAA came into effect in September 2009 will be governed by those provisions, not by the prior jurisprudence. The interpretation of sections 6(8) and 2 (1) does not come into play on this appeal. To the extent that existing case law continues to govern whatever pre-September 2009 insolvency proceedings are still in the system, those cases will fall to be decided on their own facts. We see no error in the motion judge's analysis of the jurisprudence or in his application of it to the facts of this case, and therefore see no basis for granting leave to appeal from his disposition of the equity issue in these circumstances.

Disposition

13 The motion for leave to appeal is therefore dismissed. Costs to the Monitor and to TA Associates fixed in the amount of $5,000 each, inclusive of disbursements and all applicable taxes.

R.J. SHARPE J.A.
R.A. BLAIR J.A.
P.S. ROULEAU J.A.

cp/e/qllxr/qljxr/qlmll/qlana

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2000 CarswellAlta 12, 76 Alta. L.R. (3d) 338, [2000] 4 W.W.R. 738, [2000] A.W.L.D. 183, 15 C.B.R. (4th) 169, 259 A.R. 30, 2000 ABQB 4

Blue Range Resource Corp., Re

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

In the Matter of Blue Range Resource Corporation

Alberta Court of Queen's Bench

Romaine J.

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

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Counsel: *R.J. (Bob) Wilkins* and *Gary Befus*, for Big Bear Exploration Ltd.

A. Robert Anderson and *Bryan Duguid*, for Enron Trade & Capital Resources Canada Corp.

Glen H. Poelman, for Creditors' Committee.

Virginia A. Engel, for MRF 1998 II Limited Partnership.

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

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

Respondent submitted takeover bid to obtain company by way of exchange of shares — Takeover bid was accepted and respondent became sole shareholder of company — Following takeover, respondent alleged company's shares were worthless and, as sole shareholder, caused company to apply for protection under Companies' Creditors Arrangement Act — Respondent made unsecured claim for value of shares exchanged in takeover bid — Applicant creditors of company applied for direction on preliminary issues with respect to respondent's claim — Respondent's alleged losses were inextricably intertwined with their shareholder interest in company — Creditors' claims typically had priority over those shareholders pursuant to principles of equity and assumption of risk — Claim by respondent for alleged loss and damages from share exchange was, in substance, claim by shareholder and ranked after claims of unsecured creditors — Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36.

Bankruptcy --- Proving claim — Practice and procedure — Miscellaneous issues

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Respondent submitted takeover bid to obtain company by way of exchange of shares — Takeover bid was accepted and respondent became sole shareholder of company — Following takeover, respondent alleged company's shares were worthless and, as sole shareholder, caused company to apply for protection under Companies' Creditors Arrangement Act — Respondent made unsecured claim for value of shares exchanged in takeover bid — Respondent pursued claims through two different routes by filing notice of claim for damages for share exchange loss, and filing statement of claim alleging other causes of action — Judge made orders that precluded respondent from advancing claims beyond those set out in notice of claim — Respondent sought expedited trial for hearing claim set out in draft statement of claim — Applicant creditors of company applied for direction on preliminary issues with respect to respondent's claim — Respondent was not entitled to advance claims for heads of damages in statement of claim that were not set out in notice of claim — Respondent was attempting to indirectly attack effectiveness of previous judge's order that prevented respondent from advancing claims other than those set out in notice of claim — Under other circumstances, respondent might have been able to include claims under other heads of damages by attaching draft statement of claim to notice of claim — Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36.

Fraud and misrepresentation --- Remedies — Damages — Miscellaneous issues

Respondent submitted takeover bid to obtain company by way of exchange of shares — Takeover bid was accepted and respondent became sole shareholder of company — Following takeover, respondent alleged company's shares were worthless and, as sole shareholder, caused company to apply for protection under Companies' Creditors Arrangement Act — Respondent made unsecured claim for value of shares exchanged in takeover bid — Applicant creditors of company applied for direction on preliminary issues with respect to respondent's claim — Because of negligent misrepresentation, respondent was induced to give up something that was of substantially no cost to corporation, and it did not suffer any financial loss from share exchange as shares were created from treasury — Party may not recover in tort for loss of something it never had — Alleged loss from share exchange was not loss incurred by respondent, rendering respondent improper party to bring claim — Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36.

Practice --- Parties — Standing

Respondent submitted takeover bid to obtain company by way of exchange of shares — Takeover bid was accepted and respondent became sole shareholder of company — Following takeover, respondent alleged company's shares were worthless and, as sole shareholder, caused company to apply for protection under Companies' Creditors Arrangement Act — Respondent made unsecured claim for value of shares exchanged in takeover bid — Applicant creditors of company applied for direction on preliminary issues with respect to respondent's claim — Because of negligent misrepresentation, respondent was induced to give up something that was of substantially no cost to corporation, and it did not suffer any financial loss from share exchange as shares were created from treasury — Party may not recover in tort for loss of something it never had — Alleged loss from share exchange was not loss incurred by respondent, rendering respondent improper party to bring claim — Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36.

Cases considered by *Romaine J.*:

Algoma Steel Corp. v. Royal Bank (1992), 11 C.B.R. (3d) 11, 8 O.R. (3d) 449, 93 D.L.R. (4th) 98, 55 O.A.C. 303 (Ont. C.A.) — referred to

B.G. Preeco I (Pacific Coast) Ltd. v. Bon Street Holdings Ltd. (1989), 4 R.P.R. (2d) 74, 37 B.C.L.R. (2d)

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258, 43 B.L.R. 67, (sub nom. *B.G. Preeco I (Pacific Coast) Ltd. v. Bon Street Developments Ltd.)* 60 D.L.R. (4th) 30 (B.C. C.A.) — referred to

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

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

Cohen, Re (1956), 19 W.W.R. 14, 3 D.L.R. (2d) 528, 36 C.B.R. 21 (Alta. C.A.) — distinguished

Hedley Byrne & Co. v. Heller & Partners Ltd. (1963), [1964] A.C. 465, [1963] 1 Lloyd's Rep. 485, [1963] 2 All E.R. 575, 107 Sol. Jo. 454, [1963] 3 W.L.R. 101 (U.K. H.L.) — referred to

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

Milne v. Durham Hosiery Mills Ltd., 57 O.L.R. 228, [1925] 3 D.L.R. 725 (Ont. C.A.) — referred to

National Stadium Ltd., Re (1924), 55 O.L.R. 199 (Ont. C.A.) — referred to

Newton National Bank v. Newbegin (1896), 33 L.R.A. 727, 74 F. 135, 20 C.C.A. 339 (U.S. C.C.A.8 Kan.) — referred to

Northwestern Trust Co., Re, 7 C.B.R. 440, [1926] S.C.R. 412, [1926] 3 D.L.R. 612 (S.C.C.) — considered

Oakes v. Turquand (1867), (sub nom. *Peek v. Turquand)* L.R. 2 H.L. 325, [1861-73] All E.R. Rep. 738 (U.K. H.L.) — referred to

Olympia & York Developments Ltd. v. Royal Trust Co. (1993), 17 C.B.R. (3d) 75, 8 B.L.R. (2d) 69 (Ont. Gen. Div. [Commercial List]) — referred to

Pepper v. Litton (1939), 308 U.S. 295, 84 L. Ed. 281, 60 S. Ct. 238 (U.S. Va.) — considered

R. v. Wilson, [1983] 2 S.C.R. 594, 4 D.L.R. (4th) 577, 51 N.R. 321, [1984] 1 W.W.R. 481, 26 Man. R. (2d) 194, 9 C.C.C. (3d) 97, 37 C.R. (3d) 97 (S.C.C.) — referred to

Salomon v. Salomon & Co. (1896), [1897] A.C. 22, 45 W.R. 193, [1895-99] All E.R. Rep. 33 (U.K. H.L.) — considered

Structurlite Plastics Corp., Re (1995), 193 B.R. 451 (U.S. Bankr. S.D. Ohio) — referred to

THC Financial Corp., Re (1982), 679 F.2d 784 (U.S. 9th Cir. Hawaii) — considered

Trusts & Guarantee Co. v. Smith (1923), 4 C.B.R. 195, 54 O.L.R. 144, [1924] 2 D.L.R. 211 (Ont. C.A.) — referred to

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U.S. Financial Inc., Re (1980), 648 F.2d 515, 7 Bankr. Ct. Dec. 166 (U.S. 9th Cir. Cal.) — considered

Unisource Canada Inc. v. Hongkong Bank of Canada (1998), 43 B.L.R. (2d) 226, 14 P.P.S.A.C. (2d) 112 (Ont. Gen. Div.) — referred to

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

Statutes considered:

Bankruptcy Code, 11 U.S.C. 1982

Generally — referred to

s. 510 — referred to

s. 510(b) — referred to

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

Generally — referred to

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

***Romaine J.*:**

Introduction

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

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

Facts

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

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

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

(c) it paid for the Blue Range shares sought through the takeover bid by way of a share exchange: Blue

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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 worth- less.

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);

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(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

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under corporate law when it acquired the Blue Range shares.

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

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

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

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

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

23 It is true that Big Bear does not claim recission. Therefore, this is not a claim for return of capital in the

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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.

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

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

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

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

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

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

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

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

36 The Applicants also submit that the reasoning underlying the *Central Capital Corp.* case (where the court found that retraction rights in shares do not create a debt that can stand equally with the debt of shareholders) and the cases where shareholders have attempted to rescind their shareholdings after a corporation has been

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found insolvent is analogous to the Big Bear situation, and the same result should ensue.

37 It is clear that, both in Canada and in the United Kingdom, once a company is insolvent, shareholders are not allowed to rescind their shares on the basis of misrepresentation: *Re Northwestern Trust Co.*, [1926] S.C.R. 412 (S.C.C.) at 419; *Milne v. Durham Hosiery Mills Ltd.*, [1925] 3 D.L.R. 725 (Ont. C.A.); *Trusts & Guarantee Co. v. Smith* (1923), 54 O.L.R. 144 (Ont. C.A.); *Re National Stadium Ltd.* (1924), 55 O.L.R. 199 (Ont. C.A.); *Oakes v. Turquand* (1867), [1861-73] All E.R. Rep. 738 (U.K. H.L.) at page 743-744.

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

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

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

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

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

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

43 The first of these cases is *Stirling Homex (supra)*. The issue dealt with by the United States Court of Appeals, Second Circuit, is directly on point: whether claims filed by allegedly defrauded shareholders of a debtor corporation should be subordinated to claims filed by ordinary unsecured creditors for the purposes of formulating a reorganization plan. The court referred to the decision of , 308 U.S. 295 at page 305, 60 S. Ct. 238, 84 L.

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Ed. 281 (U.S. Va. 1939)) where the Supreme Court commented that the mere fact that a shareholder has a claim against the bankrupt company does not mean it must be accorded *pari passu* status with other creditors, and that the subordination of that claim may be necessitated by principles of equity. Elaborating on this, the court in *Stirling Homex* (*supra* at page 213) stated that where the debtor corporation is insolvent, the equities favour the general creditors rather than the allegedly defrauded shareholders, since in this case, the real party against which the shareholders are seeking relief is the general creditors whose percentage of realization will be reduced if relief is given to the shareholders. The court quotes a comment made by an earlier Court of Appeals (*Newton National Bank v. Newbegin*, 74 F. 135 (U.S. C.C.A.8 Kan. 1896), 140:

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

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

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

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

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

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

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49 Big Bear submits that ascribing some legal impediment to a shareholder pursuing a remedy in tort against a company in which it holds shares violates the principle set out in *Salomon v. Salomon & Co.* (1896), [1897] A.C. 22 (U.K. H.L.) that corporations are separate and distinct entities from their shareholders. In my view, this is not in issue. What is being sought here is not to limit a tort action by a shareholder against a corporation but to subordinate claims made *qua* shareholder to claims made by creditors in an insolvency situation. That shareholder rights with respect to claims against a corporation are not unlimited has already been established by the cases on rescission and recognized by statutory limitations on redemption and retraction. In this case, the issue is not the right to assert the claim, but the right to rank with creditors in the distribution of the proceeds of a pool of assets that will be insufficient to cover all claims. No piercing of the corporate veil is being suggested or would result.

50 Counsel for Big Bear cautions against the adoption of principles set out in the American cases on the basis that some decisions on equitable subordination require inequitable conduct by the claimant as a precondition to subordinating a claim, referring to a three-part test set out in a number of cases. This discussion of the inequitable conduct precondition takes place in the broader context of equitable subordination for any cause as it is codified under Section 510 of the US Bankruptcy Code. In any event, it appears that more recent American cases do not restrict the use of equitable subordination to cases of claimant misconduct, citing, specifically, that stock redemption claims have been subordinated in a number of cases even when there is no inequitable conduct by the shareholder. "Stock redemption" is the term used for cases involving fraud or misrepresentation: *United States v. Noland*, 517 U.S. 535 (U.S. Ohio 1996); *Re Structurlite Plastics Corp.*, 193 B.R. 451 (U.S. Bankr. S.D. Ohio 1995). Some of the American cases draw a distinction between cases where misconduct is generally required before subordination will be imposed and cases where "the claim itself is of a status susceptible to subordination, such as ... a claim for damages arising from the purchase ... of a security of the debtor": *United States v. Noland (supra*, at paragraph 542).

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

52 At any rate, this case, together with *Olympia & York Developments Ltd. v. Royal Trust Co.* (1993), 17 C.B.R. (3d) 75 (Ont. Gen. Div. [Commercial List]) and *Unisource Canada Inc. v. Hongkong Bank of Canada* (1998), 43 B.L.R. (2d) 226 (Ont. Gen. Div.) all refer to the doctrine of equitable subordination codified in the U.S. Bankruptcy Code which is not in issue here. The latter two cases appear to have accepted the erroneous proposition that inequitable misconduct is required in all cases under the American doctrine.

53 Big Bear also submits that the equitable principles that exist in U.S. law which have led the courts to ignore separate corporate personality in the case of subsidiary corporations are related to equitable principles used to subordinate shareholder claims. The basis for this submission appears to be a reference by the British Columbia Court of Appeal in *B.G. Preeco I (Pacific Coast) Ltd. v. Bon Street Holdings Ltd.* (1989), 43 B.L.R.

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67 (B.C. C.A.) to the *Pepper v. Litton* case (*supra*) and the so-called "Deep Rock doctrine" under American law. I do not see a link between the comments made in *Pepper v. Litton* and referred to in *B.G. Preeco* on an entirely different issue and comments concerning the court's equitable jurisdiction in the case of claims by shareholders against insolvent corporations.

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

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

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

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

Issue #2

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

Summary of Decision

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

Analysis

60 The Applicants submit that negligence is only actionable if a plaintiff can prove that it suffered damages, as the purpose of awarding damages in tort is to compensate for actual loss. This is a significant difference between damages in tort and damages in contract. In order for a plaintiff to have a cause of action in negligent

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misrepresentation, it must satisfy the court as to the usual elements of duty of care and breach thereof, and it must establish that it has sustained damages from that breach.

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

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

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

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

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

66 It is a first principle of tort law that a person is entitled to be put in the position, insofar as possible, that he or she was before the tort occurred. While the courts were historically loath to award damages for pure economic loss, this position was softened in *Hedley Byrne & Co. v. Heller & Partners Ltd.* (1963), [1964] A.C. 465 (U.K. H.L.) where the court confirmed that damages could be recovered in this type of case. When assessing damages for negligent misrepresentation resulting in pure economic loss, the goal is to put the party who relied on the misrepresentation in the position which it would have been in had the misrepresentation not occurred. While the parties to this application appear to agree on this principle, it is the application thereof with which they disagree.

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

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> 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

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time of the share exchange, Big Bear may have a loss in the amount of the exchange value of the shares. However, there is no evidence of such a redemption or retraction feature attaching to these shares.

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

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

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

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

Issue #3

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

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

Summary of Decision

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

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Analysis

77 Big Bear submits that it is clear that, in an appropriate case, a complex liability issue that arises in the context of CCAA proceedings may be determined by a trial, including provision for production and discovery: *Algoma Steel Corp. v. Royal Bank* (1992), 11 C.B.R. (3d) 11 (Ont. C.A.). Big Bear also submits that the court has the jurisdiction to overlook technical complaints about the contents of a Notice of Claim. The CCAA does not prescribe a claim form, nor set the rules for completion and contexts of a claim form, and it is common ground that in this case, the form used for the "Notice of Claim" was not approved by any order of the court. At any rate, Big Bear submits that it is not seeking to amend its claim to add new claims or to claim additional amounts.

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

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

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

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

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

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

82 While it is true that a court has jurisdiction to overlook technical irregularities in a Notice of Claim, the issue is not whether the court should overlook technical non-compliance with, or ambiguity in, a form, but whether it is appropriate to do so in this case where previous orders have been made relating to these issues. Here, Big Bear chose to pursue its claims through two different routes. It filed a Notice of Claim alleging damages for a share exchange loss, transaction costs and the cost of shares purchased before the takeover bid, all damage claims that can reasonably be identified as being related to an action for negligent misrepresentation. At about the same time, it brought an application to lift the stay granted under the CCAA and file a Statement of Claim that alleged other causes of action. That application was dismissed, and the order dismissing it was never appealed. This is not a situation as in *Re Cohen* (1956), 19 W.W.R. 14 (Alta. C.A.) where a claim made on one

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basis was later sought to be made on a different basis, nor an issue of Big Bear lacking, the necessary information to make its claim, although quantification of damage may have been difficult to determine. Given the previous application by Big Bear, this is a collateral or indirect attack on the effectiveness of LoVecchio, J.'s orders, and should not be allowed: *R. v. Wilson* (1983), 4 D.L.R. (4th) 577 (S.C.C.) at 599). The effect of the two orders made by LoVecchio, J. is to prevent Big Bear from advancing its claim other than as identified in its Notice of Claim, which cannot reasonably be interpreted to extend beyond the claims for damages for negligent misrepresentation.

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

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

Order accordingly.

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

EarthFirst Canada Inc., Re

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

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

Alberta Court of Queen's Bench

B.E. Romaine J.

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

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

Howard A. Gorman for EarthFirst Canada Inc.

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

Subject: Insolvency

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

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

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

Company issued flow-throw common shares — Under subscription agreement for shares, company made coven-

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

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

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

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

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

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

Statutes considered:

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

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

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

Generally — referred to

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

Generally — referred to

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

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

Introduction

1 Earthfirst Canada Inc. seeks a declaration as the proper characterization of potential claims of holders of

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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 Sub- scriber;
>
> . . . . .
>
> (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

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

Analysis

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

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

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

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

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

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

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

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> 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.

Order accordingly.

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

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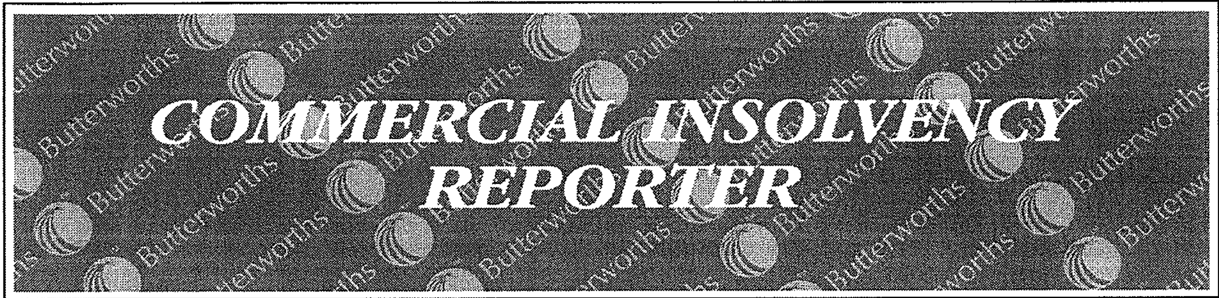

• EQUITY CLAIMS AND THE REFORM OF INSOLVENCY LEGISLATION •

Andrew Gray
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A 2009 decision of the Alberta Court of Queen's Bench in *EarthFirst Canada Inc.*[1] has brought attention again to the issue of the characterizations and rankings of equity and equity-type claims in the insolvency context. In *EarthFirst*, Madam Justice Romaine considered the status of claims of the holders of flow-through common shares in the insolvency context, in particular claims of the shareholders arising from rights to indemnification given by the company. Justice Romaine concluded that the characterization

of the claims was difficult, but that the claims were, at their core, equity claims and therefore subordinate to the claims of the company's creditors. In reaching her conclusion she considered (but could not apply) amendments to the *Companies' Creditors Arrangement Act* [*CCAA*] that were about to come into force. These amendments were intended to provide clarity and greater certainty: clarifying that equity claims are subordinate to debt claims and providing guidance to assist courts in characterizing claims as equity or debt.[2] As the relevant amendments are now in force, the *EarthFirst* decision provides an appropriate context for reviewing the origin and purpose of this aspect of insolvency law reform.

THE *EARTHFIRST* DECISION AND THE TREATMENT OF EQUITY CLAIMS

EarthFirst was a developer of renewable wind energy. EarthFirst's capital structure included flow-though common shares. Flow-through common shares are securities that are issued to help finance project development activities. The securities have the features of common shares, but are supplemented by a flow-through feature that allows the issuer to transfer (or "renounce") expenses related to project development activities to the holders of the securities. These expenses can then be applied against the earnings of the holder to reduce taxable income. If project development expenses are not renounced, the shareholder may lose part of the value of the original investment.

When EarthFirst issued its flow-through common shares, it agreed with the shareholders to incur and renounce certain project development expenses or, alternatively, to indemnify the shareholders in respect of the tax consequences of failing to do so:

> Pursuant to the Subscription Agreement, the Corporation will covenant and agree: (i) to incur on or before December 31, 2008, and renounce to the Flow-Through Subscriber effective on or before December 31, 2007, CEE in an amount equal to the aggregate purchase price paid by such Flow-Through Subscriber, and (ii) that if the Corporation does not renounce to such Flow-Through Subscriber, effective on or before December 31, 2007, CEE equal to such amount, or if there is a reduction in such amount renounced pursuant to the provisions of the Tax Act, the Corporation shall indemnify the Flow-Through Subscriber as to, and forthwith pay in settlement thereof to such Flow-Through Subscriber, an amount equal to the amount of any tax payable or that may become payable under the Tax Act (and under any corresponding provincial legislation) by the Flow-Through Subscriber as a consequence of such failure or reduction. [Emphasis added.][3]

On November 4, 2008, EarthFirst commenced proceedings under the *CCAA*. As part of the *CCAA* proceedings, EarthFirst sought a purchaser for its Dokie I wind power project, whose development was a condition of allowing the company to meet its obligation to renounce project development expenses. Because the sale and continued development of the Dokie I project was uncertain, it was possible that EarthFirst would be unable to meet its obligation to renounce project development expenses. This would give rise to claims in respect of the rights to indemnification promised by EarthFirst. EarthFirst therefore sought a declaration from the Court as to the status of the rights to indemnification that the holders of the flow-through common shares could have.[4]

Justice Romaine had to consider whether the rights to indemnification that the holders of the flow-through common shares could have were debt claims or equity claims. She found that those claims were at their core equity claims. She noted that equity claims may have some features of a debt, and that in some instances equity may be transformed and become debt, making the characterization of the claims difficult. In respect of the flow-though shares of EarthFirst, the rights to indemnification were merely "sweeteners" associated with the sale of those securities. She also noted that the claims derived from the status of the claimants as subscribers for the flow-through common shares, and that the purpose of the claims was to recoup a portion of what had originally been invested by the holders of the flow-through shares — in essence, a claim for the return of the equity investment. Justice Romaine held that the renunciation of project development expenses was merely an incidental aspect of the flow-through shares, secondary to the common share features of the securities.[5] She noted the difficulty in this case of characterizing the claims, acknowledging that "this type of indemnity skirts close to the line that courts are attempting to draw with respect to the characterization and ranking of equity and equity-type investments in the insolvency context."[6]

In concluding that the claims of the holders of EarthFirst's flow-through common shares must rank behind the claims of creditors, Romaine J. noted that the position of the shareholders was analogous to the position of similarly situated shareholders in *National Bank of Canada v. Merit Energy Inc.*,[7] making the difficult line-drawing exercise easier for the court in *EarthFirst*. In *Merit Energy*, Mr. Justice LoVecchio had also considered claims for indemnification made by the holders of flow-through common shares, and he held that they were also equity claims:

> The second claim of the Flow-Through Shareholders has some of the features of a debt and the Subscription and Renunciation Agreements provide for a specific remedy in the event Merit fails to comply with its undertaking to make and renounce the CEE expenditures.
>
> ... The tax advantages associated with flow-through shares is reflected in a premium paid for the purchase of the shares. In essence, what happens in a flow-through share offering (as sanctioned by the Income Tax Act) is the shareholder buys deductions from the company. As the company has given up deductions, it wants to be paid for those deductions that it is renouncing. From the perspective of the purchaser of the shares, the premium for the shares would not have been paid without some assurance that the deductions will be available. I note the purchaser is also required to reduce their adjusted cost base of the shares (for tax purposes) by the amount of the deductions utilized by the purchaser.
>
> While the Flow-Through Shareholders paid a premium for the shares (albeit to get the deductions), in my view the debt features associated with the CEE indemnity from Merit do not "transform" that part of the relationship from a shareholder relationship into a debt relationship. That part of the relationship remains "incidental" to being a shareholder.
>
> In summary, the Flow-Through Shareholders' claims, regardless of the basis chosen to support them, are in substance claims for the return of their equity investment and accordingly cannot rank with Merit's unsecured creditors.[8]

In addition to relying on this reasoning from *Merit Energy*, Romaine J. considered amendments to the *CCAA* that had been passed by Parliament but not proclaimed into force at the time the *EarthFirst* decision was made. Those amendments to the *CCAA* (as discussed below) explicitly address the status of equity claims in insolvency proceedings. Among other things, the amendments prohibit the payment of dividends in respect of equity claims until all other claims are satisfied, and they define equity claims very broadly to capture all claims relating to equity interests, including, therefore, claims relating to the flow-through common shares.

While Romaine J. could not apply these amendments to the claims of the holders of EarthFirst's flow-though common shares, the reference to them suggests that, had the amendments been in force, they would have been determinative of the issue. The amendments, if they could have been applied, would therefore have made the line-drawing exercise for equity claims much easier because the claims at issue were captured by the amended *CCAA*. The amendments to the *CCAA*, and the related amendments to the *BIA*, were intended to have this effect to make it easier to deal with equity claims in insolvency proceedings, and to bring certainty to this area of the common law.

THE STATUS OF THE COMMON LAW REGARDING EQUITY CLAIMS

In *Merit Energy*, LoVecchio J. had reviewed the status of the common law as it relates to characterizing equity claims in the insolvency context. The position of equity claims relative to debt claims is clear: they rank behind claims of creditors in insolvency, but characterizing a claim as equity or debt is often a difficult interpretative exercise, as Romaine J. acknowledged in *EarthFirst*.[9]

The Supreme Court of Canada addressed the characterization issue in *Canada Deposit Insurance Corp. v. Canadian Commercial Bank*.[10] In that case, the Supreme Court had to determine whether an agreement to participate in a portion of a bank's loan portfolio was an equity investment or a loan. The Supreme Court noted that the characterization exercise was a matter of interpreting the agreements in question to see what the parties reasonably intended, and that the exercise could be a difficult one. Writing for the Court, Mr. Justice Iacobucci stated that "the characterization issue facing this Court must be decided by determining the intention of the parties to the supporting agreements. This task, perplexing as it sometimes proves to be, depends primarily on the meaning of the words chosen by the parties to reflect their intention."[11] In *CDIC*, the agreements included characteristics associated with both debt and equity financings, but in substance the agreement was a loan agreement. Reaching this conclusion was not a straightforward matter, as reflected in the Court's reasoning:

> Instead of trying to pigeonhole the entire agreement between the Participants and CCB in one of two categories, I see nothing wrong in recognizing the arrangement for what it is, namely, one of a hybrid nature, combining elements of both debt and equity but which, in stance, reflects a debtor-creditor relationship. Financial and capital markets have been most creative in the variety of investments and securities that have been fashioned to meet the needs and interests of those who participate in those markets. It is not because an agreement has certain equity features that a court must either ignore these features as if they did not exist or characterize the transaction on the whole as an investment. There is an alternative. It is permissible, and often required, or desirable, for debt and equity to coexist in a given financial transaction without altering the substance of the agreement. Furthermore, it does not follow that each and every aspect of such an

> agreement must be given the exact same weight when addressing a characterization issue. Again, it is not because there are equity features that it is necessarily an investment in capital. This is particularly true when, as here, the equity features are nothing more than supplementary to and not definitive of the essence of the transaction. When a court is searching for the substance of a particular transaction, it should not too easily be distracted by aspects which are, in reality, only incidental or secondary in nature to the main thrust of the agreement.[12]
> [Emphasis in the original]

In *Re Central Capital Corporation*,[13] the Court of Appeal for Ontario had to characterize a claim arising from the right of retraction in respect of certain preference shares: did the holders of those preference shares have a provable claim under the *BIA* in respect of the right to require the company to redeem the preference shares? Although the relationship of the holders of the preference shares had characteristics of both debt and equity, the Court of Appeal held that, in substance, the holders of the preference shares had equity claims with respect to their right of retraction, which provides for the return of capital, not for the repayment of a loan.

As Romaine J. noted in *EarthFirst*, an equity claim may also be transformed into a debt claim, and whether or when this happens is a matter of characterization. Some of the claims of issue in *Merit Energy*, and claims at issue in an earlier decision of Romaine J. in *Blue Range Resource Corporation*,[14] were claims by shareholders for damages based on misrepresentations made when their shares were acquired. The courts in both cases held that the fact that the shareholders may have claims in tort does not transform those claims into debt claims — the claims remained equity claims because they were derived from the claimants' status as shareholders and in connection with the equity investment. In *Blue Range*, Romaine J. held that the claim of the shareholder (Big Bear) was in substance an equity claim:

> It is true that Big Bear does not claim recission. Therefore, this is not a claim for return of capital in the direct sense. What is being claimed, however, is an award of damages measured as the difference between the "true" value of Blue Range shares and their "misrepresented" value — in other words, money back from what Big Bear "paid" by way of consideration ... A tort award to Big Bear could only represent a return of what Big Bear invested in equity of Blue Range. It is that kind of return that is limited by the basic common law principle that shareholders rank after creditors in respect of any return on their equity investment.[15]

This analysis and the conclusion accord with the policy rationale that underlies the ranking of equity and debt claims in the insolvency context, identified by Romaine J. in *Blue Range*: even defrauded shareholder claimants are presumed to have bargained for equity-type profits, and assumed equity-type risks, whereas creditors are presumed to have dealt with the company on the basis that their claims were in priority to such shareholder claims.

While in *Merit Energy* and *Blue Range* the shareholders' claims were characterized as equity claims, the Court came to a different conclusion in *Re I. Waxman & Sons Limited*.[16] In that case, the claimant had obtained a judgment in an oppression action in his capacity as a shareholder. However, the Court concluded that this claim, which began in equity, was properly characterized as a debt claim: "By virtue of the judgment, the money award becomes debt and is properly the subject of a proof of claim in bankruptcy. In this regard, the facts in this case are unlike those in [*Blue Range*] or [*Merit Energy*]. Those cases involved causes of action that had been asserted in court proceedings but in neither case had judgment been rendered."[17]

More recently, an inter-company claim in *Smurfit-Stone Container Canada Inc.* had to be characterized as part of a *CCAA* proceeding.[18] A loan had been advanced between affiliates, the terms of which required that, on an insolvency, the loan would be repayable in shares of the borrower. The borrower argued that the parties intended the investment to be an equity investment in the event of an insolvency, and therefore the claim should be characterized as an equity claim. The Court rejected this argument, finding that the intention of the parties, as revealed by the agreement between them, was that the investment was a loan, albeit one repayable in equity in certain circumstances.[19]

REFORM OF INSOLVENCY LAW

As the cases discussed above indicate, the characterization of claims as debt claims or equity claims can be difficult, resulting in uncertainty. This led to the reform of insolvency law and the amendments to the *CCAA* that Romaine J. referred to in *EarthFirst*, and to parallel amendments to the *BIA*.

The need for reform, and the suggested scope of the reform, was addressed in 2002 by the Insolvency Institute of Canada and the Canadian Association of Insolvency and Restructuring Professionals in the *Report of the Joint Task Force on Business Insolvency Reform*.[20] The Joint Task Force recommended that insolvency legislation be amended to address the circumstances that arise in the cases discussed above, and to provide that "all claims against a debtor in an

insolvency proceeding that arise under or relate to an instrument that is in the form of equity, including claims for payment of dividends, redemption or retraction or repurchase of shares and damages (including securities fraud claims) are to be treated as equity claims subordinate to all other secured and unsecured claims against the debtor."[21] The list of specific claims in the proposal captures the kinds of claims that were at issue in *Central Capital*, *Merit Energy*, *Blue Range* and *EarthFirst*. The principled rationale for the proposed reform was consistent with the principles identified by Romaine J. in *Blue Range* and applied by the Court in that case: equity investors bargain for claims of lower priority than debt claims. Clarifying this in amendments to the *CCAA* and *BIA* would provide greater certainty.

The Standing Senate Committee on Banking, Trade and Commerce came to the same conclusion in a 2003 report. The Committee recommended that insolvency legislation should be amended to clarify the subordination of equity claims: "their claims should be afforded lower ranking than secured and unsecured creditors, and the law — in the interests of fairness and predictability — should reflect both this lower priority for holders of equity and the notion that they will not participate in a restructuring or recover anything until all other creditors have been paid in full."[22]

The recommended reform to insolvency law was ultimately passed into law as amendments to the *CCAA* and *BIA*. The amendments addressing the status of equity claims were presented in Bill C-12 in 2007, and came into force on September 18, 2009.[23]

The amendments to the *CCAA* and *BIA* effected through Bill C-12 clearly subordinate equity claims. The amendments exclude the entire class of creditors having "equity claims" from the right to vote on a plan or proposal unless the court orders otherwise, and they prohibit the court from approving a plan or proposal that provides for the payment of an equity claim, unless all other claims are to be paid in full before the equity claims are paid.[24] The amendments, in addition, provide that equity claims based on misrepresentations (*i.e.*, the claims in *Merit Energy* and *Blue Range*) may be compromised in a plan or proposal, and will be discharged in a bankruptcy.[25]

The amendments define "equity claim" very broadly to include any claim relating to an "equity interest," defined as a share in a corporation, including a warrant, option or other right to acquire a share, or in the case of an income trust an income trust unit or an option, warrant or other right to acquire a unit in the income trust. An "equity claim" is defined in the amendments as follows:

> a claim that is in respect of an equity interest, including a claim for, among others,
>
> (a) a dividend or similar payment,
>
> (b) a return of capital,
>
> (c) a redemption or retraction obligation,
>
> (d) a monetary loss resulting from the ownership, purchase or sale of an equity interest or from the rescission, or, in Quebec, the annulment, of a purchase or sale of an equity interest, or
>
> (e) contribution or indemnity in respect of a claim referred to in any of paragraphs (a) to (d)[26]

The stated purpose of the amendments is consistent with the recommendations and proposals that preceded them. Industry Canada's clause-by-clause analysis of the amendments notes, in reference to the provision in the *CCAA* restricting the voting rights of creditors with equity claims, that "[t]he amendment is one of several made with the intention of classifying that equity claims are to be subordinate to other claims. Equity claims are ownership interests, and as such, should be subject to the risks of insolvency."[27] In order to achieve that intended purpose, the amendments have defined equity claims as broadly as possible to include any claim that relates to an equity interest, including but not limited to the kinds of claims dealt with in cases such as *Central Capital*, *Merit Energy*, and *Blue Range*.

CONCLUSION

In referring to the amendments to the *CCAA* in *EarthFirst*, Romaine J. suggests that, had she been able to apply them, the characterization exercise in respect of the claims of the holders of flow-through common shares would have been less difficult because the claims would have fallen squarely within the broad definition of equity claims included in the amendments to the *CCAA*, and therefore would have clearly been subordinate to equity claims in the ways specified by the *CCAA*. It remains to be seen whether the amendments to the *CCAA* and *BIA* will make the characterization of claims as equity or debt less difficult, thereby bringing clarity and certainty to this area of insolvency law.

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1 [2009] A.J. No. 749, 2009 ABQB 316 (Q.B.) [*EarthFirst*].

2 The amendments to the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36 [*CCAA*] and the

Bankruptcy and Insolvency Act, R.S.C 1985, c. B-3 [*BIA*], and the background to the amendments, are described below in the third section of the article.

3 This description of the obligation is quoted from the prospectus of EarthFirst, dated November 27, 2007 and accessed through <www.sedar.com>.

4 EarthFirst ultimately entered into an agreement to sell the Dokie I project, and the asset purchase agreement included a covenant by the purchaser to make reasonable commercial efforts to complete the steps necessary to allow project development expenses to be renounced to the holders of the flow-though common shares. EarthFirst exited the *CCAA* proceedings by amalgamating with Maxim Power Corp. in March 2010.

5 *EarthFirst*, *supra* note 1 at para. 4.

6 *Ibid.*

7 *National Bank of Canada v. Merit Energy Ltd.*, [2001] A.J. No. 918, 2001 ABQB 583 (Q.B.) [*Merit Energy*].

8 *Ibid.* at paras. 52-55.

9 *Ibid.* at paras. 23 to 30.

10 [1992] S.C.J. No. 96, [1992] 3 SCR 558 [*CDIC*].

11 *CDIC*, *supra* note 10 at para. 51.

12 *CDIC*, *supra* note 10, at para. 54.

13 [1996] O.J. No. 359, 27 O.R. (3d) 494 (C.A.) [*Central Capital*].

14 [2000] A.J. No. 14, 15 CBR (4th) 169 (Alta. Q.B.) [*Blue Range*].

15 *Ibid* at para. 23.

16 [2008] O.J. No. 885 (S.C.J.) [*Waxman*].

17 *Ibid* at para. 25.

18 Unreported decision of the Honourable Madam Justice Pepall, Ontario Superior Court of Justice, January 28, 2010, accessed online at <http://www.deloitte.com/view/en_CA/ca/specialsections/insolvencyandrestructuringproceedings/smurfit-stonecontainercanada/index.htm> [*Smurfit Stone*].

19 The court in *Smurfit Stone* went on to find that, although the claim was a debt claim, it was not a claim provable in bankruptcy within the meaning of s. 121 of the *BIA*, and was therefore not a claim for the purposes of s. 12(1) of the *CCAA*.

20 Insolvency Institute of Canada and the Canadian Association of Insolvency and Restructuring Professionals, *Report of the Joint Task Force on Business Insolvency Reform*, March 2002. Some of the background that preceded the amendments is discussed in an excellent article by J. Sarra, "From Subordination to Parity: An International Comparison of Equity Securities Law Claims in Insolvency Proceedings," 16 Int. Insolv. Rev. (2007) 181.

21 *Ibid.* proposal #62.

22 Senate Standing Committee on Banking, Trade and Commerce, *Debtors and Creditors Sharing the Burden: A Review of the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act*, November 2003, at 158-159.

23 Bill C-12, *An Act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act, the Wage Earner Protection Program Act and chapter 47 of the Statutes of Canada, 2005.* The legislation had a long history, having been introduced through a prior bill (Bill C-55) that was passed but never proclaimed into force. For the background, see: Legislative Summary, *Bill C-12: An Act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act, the Wage Earner Protection Program Act and chapter 47 of the Statutes of Canada, 2005*, accessed online at <www2.parl.gc.ca/Sites/LOP/LegislativeSummaries>.

24 *CCAA*, ss. 6(1), 6(8), 22.1; *BIA*, ss. 54.1, 54(2)(d), 60(1.7).

25 *CCAA*, s. 9(2)(d); *BIA*, s. 178(1)(e).

26 *CCAA*, s. 2(1); *BIA*, s. 2.

27 Industry Canada, *Bill C-12: Clause by Clause Analysis*, accessed online at <http://www.ic.gc.ca/eic/site/bsf-osb.nsf/eng/br01978.html>. See, also the analysis of the earlier amendments in Bill C-55: Industry Canada, *Bill C-55: Clause by Clause Briefing Book*, accessed online at <http://www.ic.gc.ca/eic/site/cilp-pdci.nsf/eng/cl00833.html>.

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DISCOVER SOMETHING GREAT

From Subordination to Parity: An International Comparison of Equity Securities Law Claims in Insolvency Proceedings

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Abstract

Securities law claims in insolvency proceedings raise important questions of allocation of risk and remedies. In the ordinary course of business, equity claims come last in the hierarchy of claims during insolvency. What is less clear is whether this should encompass claims arising from the violation of public statutes designed to protect equity investors. Discerning the optimal allocation of risk is a complex challenge if one is trying to maximize the simultaneous advancement of securities law and insolvency law public policy goals. From a securities law perspective, there must be confidence in meaningful remedies for capital markets violations if investors are to continue to invest. From an insolvency perspective, creditors make their pricing and credit availability choices based on certainty regarding their claims and shifting those priorities may affect the availability of credit. The critical question is the nature of the claim advanced by the securities holder and whether subordination of securities law claims gives rise to inappropriate incentives for corporate officers within the insolvency law regime. A comparative analysis reveals that the U.S. has provided a limited statutory exception to complete subordination through the fair funds provision of the *Sarbanes-Oxley Act* by allowing SEC claims for penalties and disgorgement to rank equally with unsecured claims even though the funds are distributed to shareholders. The U.K. and Australian schemes permit shareholders to claim directly as unsecured creditors for fraudulent acts and misrepresentation by the issuer. In contrast, Canadian law is underdeveloped in its treatment of such claims. The paper canvasses the policy options available to reconcile securities law and insolvency law claims, including a discussion of the appropriate gatekeeping role for

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regulatory authorities and the courts, and the need for a framework that offers fair and expeditious resolution of such claims. If the public policy goal of both securities law and insolvency law is to foster efficient and cost-effective capital markets, it seems that the systems need to be better reconciled than currently. The paper also examines the codified response to the time and resources consumed in various common law tracing claims by customers in a securities firm insolvency. Copyright © 2007 John Wiley & Sons, Ltd.

I. Introduction

In an era of global capital markets, investors are seeking to maximize return and minimize risk in their investment choices. Part of that decision-making involves a choice of debt, equity and/or hybrid investments that have both debt and equity features. When companies are financially healthy, creditors can expect to receive the face value of their debt instrument plus interest and charges, while equity investors seek return through dividends from profits and appreciation in the share price. Moreover, where corporations and their officers have engaged in fraudulent disclosure (or non-disclosure), equity investors can seek to recover damages based on the loss in value of their shares resulting from the fraudulent conduct.

On insolvency, creditors rank ahead of equity investors, whose equity interests rank after creditor claims as part of the ordinary business risk that they chose. However, the question arises as to whether an equity investor's claim for fraud damages should rank after creditor claims because the damages relate to an equity interest, or whether the damages claim instead should rank *pari passu* with creditor claims because the damages relate to fraudulent conduct rather than to the fundamental nature of the equity investment. This question engages our notions of the nature of equity and debt investment, and the broader public policy question of what legal framework should govern claims arising out of violation of securities law and other fraudulent conduct when the firm is in financial distress.[1]

Securities law and insolvency law both perform important public policy functions in modern capital markets. Securities law is aimed generally at the protection of investors and the creation of efficient capital markets. Insolvency law is aimed at providing a fair and efficient mechanism for creditors to realize on their claims and at providing a framework for the rehabilitation of a company where there is a viable going forward business plan that is acceptable to creditors. In most jurisdictions, both legal regimes are enabling, in that they generally regulate only to the extent necessary to advance the public policy goals, but leave considerable room for equity investors, creditors, and corporate officers to make their own business decisions about debt or equity investments in the firm. Both regulate different aspects of the provision of capital to business enterprises and their proper functioning is important to the economy.

1. The *Sons of Gwalia* case in Australia, which is considered at length in part E of this paper, involved claims that arose out of an unfair trade practices statute rather than Australia's actual securities laws, as discussed below; *Sons of Gwalia Ltd vs. Margaretic* (2007) HCA 1.

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Securities law and insolvency law regimes intersect at the point that a firm is in financial distress and unable to pay its creditors in full. Public policy in many jurisdictions has chosen to subordinate (or "postpone" in the lingo of some countries) the damages claims of equity investors to those of regular creditors on the basis that equity investors, in seeking the unlimited upside potential of an equity investment, should be subject to the downside risks of equity, even if those risks arise as a result of the company's fraud rather than its normal market performance. Increasingly, however, the intersection of these regimes and the interests that they protect has created new tensions, in part because many jurisdictions have shifted from liquidation to restructuring regimes, in part because investors have been harmed by the misconduct of corporate officers to an extent and manner not historically considered part of ordinary business risk, and in part because many jurisdictions have made it easier for shareholders to pursue fraud claims through contingency fee or third party funding arrangements. This last point is critically important. In a "loser pays" litigation environment, shareholders simply are not going to risk their own funds seeking recovery from an insolvent company; that is why such cases are rare. However, if the lawyer takes the risk through a contingency fee, or a litigation funder takes the risk by indemnifying against costs awards, then the claims will be asserted, as is occurring in Australia. This paper begins to explore the contours of this intersection between insolvency law and securities law.

There have been an increasing number of cases in which insolvencies are either precipitated by securities law claims, or the securities claims of equity investors arise during the course of insolvency proceedings. In large measure, these claims are a function of relatively new statutory remedies granted to securities holders in the post-*Sarbanes Oxley* era of enhanced disclosure and governance requirements and of increased enforcement by securities authorities based on fraud and other misconduct.[2] In a number of jurisdictions, investors have been granted additional rights to bring civil actions against directors and officers for alleged failure to meet statutory disclosure requirements and/or fraudulent conduct. Given the nature of securities, which can be debt or equity or some combination, the treatment of these claims in insolvency proceedings has been somewhat uncertain, particularly when securities holders are aggressively pursuing remedies in the ordinary courts. Increasingly, there have been complex class action suits filed concurrently with insolvency proceedings.

Just as healthy insolvency laws help to foster robust capital markets through certainty in credit decisions, effective securities legislation is a key to enhancing global capital markets by fostering fair and efficient capital raising processes and confidence in public capital markets through the protection of investors. Yet the regimes may be in conflict in certain circumstances. For example, litigation alleging securities law violations can be complex, time-consuming, and expensive for security holders and debtors alike, and can work to defeat the goal of an expeditious resolution of a debtor's insolvency. The claims of equity securities holders create a risk to timely realization of creditors' claims at the point of firm financial distress. For jurisdictions with federal legislative

2. *Sarbanes-Oxley Act of* 2002, Pub. L. No. 107-204, 116 Stat. 745, codified in Titles 11, 15, 18, 28, and 29 U.S.C. (2002).

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structures, there also may be paramountcy questions in respect of insolvency and securities laws. At the heart of these issues is how to distribute losses during firm insolvency.

There continues to be a gap in information about the intersection of insolvency law and securities law. Both areas are highly specialized areas of practice and scholarship, each with limited understanding or sympathy for the particular policy choices of the other statutory scheme and the priority, protection, and remedies that have been fashioned to advance the particular public policy underlying the regime. Yet a better understanding of their intersection is necessary if we are to advance the goals of both regimes to stimulate robust capital markets. The tension between securities law and insolvency law has generated a number of questions. How does domestic law treat securities law claims in the context of restructuring or liquidation proceedings? Should securities law claims be dealt with in the context of insolvency proceedings or in concurrent securities regulatory proceedings? How can one protect, if possible, the reasonable expectations of both debt and equity investors in reconciling these legal regimes? Should there be different treatment of securities claims depending on whether they arise out of primary or secondary markets? The paper begins to explore these questions by examining the policy choices made by several jurisdictions.

The remainder of Part I briefly defines securities for purposes of this paper. Part II examines the treatment of securities claims in insolvency, in particular, examining when claims are subordinated or postponed and when they are not, including tensions in the allocation of risk. It considers the different judicial approaches to interpreting statutory language and the common law in the U.S., Canada, the U.K., and Australia. Part III offers several policy options for treatment of claims arising out of securities law violations.

There have also been failures of securities firms, such as brokerage companies, and the insolvency of such firms pose their own challenges, given the myriad ways that such firms hold assets for investors. The insolvency of a securities firm can raise questions regarding the nature of the assets and what may be distributable to creditors. Several jurisdictions have enacted special statutory regimes to address the insolvency of securities firms, some within existing insolvency legislation and some creating a separate, complementary, legislative scheme. Part IV examines Canada and the United States as examples of statutory regimes that have created special mechanisms for addressing securities firm insolvency. While the treatment of claims in these situations arises directly out of property and tracing claims, it is another example of where securities law and insolvency law intersect.

A. Defining securities

It is important to have a working definition of securities for purposes of the discussion here, as the nature and type of securities products is rapidly evolving and legal regimes are trying to keep pace with the developments.[3] For purposes of this paper, the definition is that used by Canadian bankruptcy and insolvency legislation, specifically,

3. For a discussion of the range of securities beyond shares or bonds, see M. Condon, A. Anand, and J. Sarra, *Securities Law in Canada* (Toronto: Emond Montgomery, 2005) at 183–191.

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"security" means any document, instrument or written or electronic record that is commonly known as a security, and includes, without limiting the generality of the foregoing, (a) a document, instrument or written or electronic record evidencing a share, participation right or other right or interest in property or in an enterprise, including an equity share or stock, or a mutual fund share or unit, (b) a document, instrument or written or electronic record evidencing indebtedness, including a note, bond, debenture, mortgage, hypothec, certificate of deposit, commercial paper, or mortgage-backed instrument, (c) a document, instrument or a written or electronic record evidencing a right or interest in respect of an option, warrant or subscription, or under a commodity future, financial future, or exchange or other forward contract, or other derivative instrument, including an eligible financial contract, and (d) such other document, instrument or written or electronic record as is prescribed.[4]

This definition captures all the instruments recognized in Canada as securities for the purpose of insolvency law. It mirrors the definition of security under securities law, including both debt and equity instruments sold or traded in the market. The definition blurs the distinction between security instruments or certificates, both the paper element and the electronic record keeping, and the actual security in the sense of a party's right, title, or interest in something. While securities law in many jurisdictions regulates debt and equity instruments together, in insolvency, debt is treated differently than equity investments, both in terms of priority of claims for payment, but also in the special treatment accorded to some forms of securities, such as eligible financial contracts. Hence, for purposes of this paper, a distinction must be made between the types of securities claims, specifically: equity claims, debt claims, and those investments that are a hybrid of debt and equity where the categorization of that investment may be a function of the status of the instrument at the time of the insolvency.

Insolvency law treatment of securities claims must also deal with the issue of beneficial securities holders. Today, public securities are almost always held electronically by central depositories or by brokerage firms, registered in the name of such firms as a mechanism to facilitate timely and efficient trading of securities. Investors are thus often only beneficial owners of the securities, not the registered owners. Both corporate laws and securities laws have undergone substantial revisions to reflect the changing nature of securities ownership, to protect such investors and to ensure that they maintain access to residual monitoring and control rights that were classically available only to registered security holders. Beneficial holders may not be readily identifiable and yet they may have a claim on the debtor's assets for the value, if any, of the security, but also in respect of the conduct of the debtor or its officers in the period leading up to opening of an insolvency or bankruptcy proceeding. Hence, when considering the intersection of securities law and insolvency law, it is important to bear in mind the many types of securities.

Where equity claims are specifically addressed in this paper, they are referred to as equity claims, whereas references to securities are a reference to the broader

4. Adopted from section 253 of the Canadian *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3, as amended (*BIA*).

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definition of security under the statutes. The hard definitional question is whether claims of equity security holders arising out of violations of securities law statutes should be categorized as debt or equity claims for purposes of treatment under insolvency law. It is those claims that are a primary focus of this paper.

II. Treatment of the Interests and Claims of Equity Investors During Insolvency

There is a tension between remedies under securities law and insolvency law in respect of the treatment of claims for alleged misrepresentation, failure to disclose, fraud and other violations under securities law or similar investor and consumer protection statutes. In some jurisdictions, this tension has been resolved by clear statutory language.[5] In other jurisdictions, the statutory language and recent judicial pronouncements have raised new policy issues in respect of trying to reconcile both the objectives and substantive provisions of the two regimes.[6]

Most jurisdictions follow the so-called "absolute priority rule" by providing that creditors must be paid in full in insolvency proceedings before equity holders are entitled to a distribution on their shares during insolvency. Greece, France, Germany, Brazil, Australia, the U.K., and the U.S. are just a few examples. The policy rationale is that equity investors reap the benefits of any upside value created by the wealth generating activities of a company and also take the risks associated with failure of the company. In contrast, creditors agree only to repayment of the amount owing to them plus interest. While not entitled to any profits generated, creditors do not assume the risk of loss of their investment in the same way, although arguably, at least for senior creditors, insolvency risk is factored into the pricing and availability of credit.

Insolvency law is aimed generally at maximizing the value of the estate in order to meet creditors' claims and equity holders generally rank behind creditors. Typically, there is express statutory language that specifies that shareholders' or members' interests rank after unsecured creditors.[7] There is often also statutory language specifying that shareholders are liable to pay into the insolvency estate money that they committed to subscribe for shares, which had not yet been paid at the time of the insolvency. An unpaid subscription is an asset of the estate to be realized on, and is not dependent on the status of the party who subscribed. While at common law, there were cases in which shareholders alleged they did not have to pay for subscribed shares owing, the courts generally have held that shareholders are bound to meet such obligations, as it increases the pool of capital available to creditors on liquidation.

The extensive amendments to securities laws in many jurisdictions over the last few decades have raised new issues, however, in respect of the treatment of shareholder interests. Many jurisdictions have adopted extensive continuous disclosure regimes for publicly traded companies, and provided investors with access to remedies based either on a reasonable investor test or a market impact test. Although these

5. For example, the United States.

6. For example, the U.K. and Australia, which are discussed below in Part E.

7. See for example, Germany's *Insolvenzordnung*, InsO, as amended; Thailand's *Public Companies Act*, B.E. 2535, s. 172.

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tests vary slightly in their approach, generally, jurisdictions require a company to disclose material facts, material changes or material information that might impact the value of the investment or that might influence the decisions of investors to buy, sell or hold their securities. A failure to comply with these provisions gives rise to new remedies for fraud and misrepresentation, in particular, civil remedies for a company's failure to meet statutory disclosure requirements. Given that these remedies are not the usual claims by shareholders to a residual share of the value of the assets, but rather, claims by investors for compensation for the injury to the value of their investments, the issue is whether they are "interests" to be subordinated or postponed in the same manner as equity claims when the company becomes insolvent or "claims" to be treated *pari passu* with other unsecured claims against the company.[8]

In some jurisdictions, such as the U.S., damages claims arising out of breach of statutory disclosure obligations are clearly subordinated to creditors under bankruptcy legislation. In other jurisdictions, such as the U.K. and Australia, the statutory language subordinating claims differs, and recent judgments indicate that the courts have adopted a purposive and integrative approach in trying to reconcile the securities law and insolvency law regimes. Both of these approaches are discussed below. The public policy concern is that on the one hand, creditors are entitled to some certainty in respect of where their claims are placed in the hierarchy of credit. Hence, subordinating shareholders' claims creates greater certainty and increases the pool of capital available to creditors at the point of insolvency because they do not share on a *pari passu* basis with equity investors. Creditors should reasonably expect to be paid in the normal course, but on insolvency, expect that they have access to the value of the debtor corporation to realize their claims.

On the other hand, subordinating all claims of equity investors fails to recognize that equity investors, while investing in ordinary business risk and risk of insolvency, do not assume risk of corporate fraud or violations of securities legislation, fair trade practices legislation, or criminal codes. Such subordination arguably punishes the innocent shareholder for the misconduct of corporate management, which was never part of the shareholders' bargain. Moreover, it treats shareholders' rights to statutory remedies differently in and outside of insolvency, whereas creditors do not face this differential treatment.

A. Subordination of equity claims in the United States

At first impression, the U.S. has a strict subordination regime, where shareholder claims of all types are subordinated to those of creditors. However, in the past 5 years the "shareholder claims last" policy has been tempered by the fair funds provisions of the *Sarbanes-Oxley Act*. The result overall is that while equity claims continue to be subordinated in bankruptcy proceedings, shareholders as investors can receive

8. For ease of reference, I shall refer to both insolvency and bankruptcy as insolvency, appreciating that some jurisdictions treat these as distinct phases in the debtor's financial life cycle or as applying to different types of debtors, given that in some countries, only individuals are subject to "bankruptcy" laws while corporations are separately dealt with under corporate law.

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remedies for securities law harms in some circumstances on a basis equal to unsecured creditors, as discussed below.

The absolute priority rule under the U.S. *Bankruptcy Code* clearly specifies that all creditors must be paid in full before shareholders are entitled to receive any distribution, a rule that is largely uncontested in respect of the ordinary business risk that shareholders assume in their investment decisions.[9] However, the *Bankruptcy Code* also expressly subordinates claims arising from rights to rescission and claims for damages arising from the purchase or sale of a security. Section 510(b) specifies:

> For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal to the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock.[10]

The underlying policy rationale for enacting the provision was that unsecured creditors rely generally on the equity provided by shareholder investment to assist in ensuring trade credit is repaid; shareholders invest understanding that they are undertaking a higher degree of risk and they should justifiably bear the risk of misleading or fraudulent conduct; and it is unfair to allow shareholders to make rescission claims in respect of securities fraud by the debtor such that they are competing with creditors for a limited pool of capital.[11] Equity investors enjoy the potential of substantial returns on their investment whereas creditors can realize only on the amount of their claim and the interest agreed to under the debt instrument; and the *quid pro quo* of shareholders' upside potential is that they do not rank on par with creditors in the event of insolvency and the lack of sufficient value in the assets to cover all claims. Hence, U.S. bankruptcy law allocates securities law risks in insolvency proceedings to the equity investors.

The U.S. courts have interpreted the statutory language broadly to subordinate the claims of shareholders to those of unsecured creditors, finding that claims that have a nexus or causal relationship to the purchase or sale of securities, including damages arising from alleged illegality in sale or purchase or from corporate misconduct, are to be subordinated.[12] There are judicial pronouncements to the effect

9. 11 U.S.C. §726 (applicable to Chapter 7 liquidations) and § 1129(b) (applicable to Chapter 11 reorganizations).

10. This provision was introduced in 1978. The court does, under § 510(c) of the U.S. *Bankruptcy Code* retain a power under the principles of equitable subordination, to exercise its authority to subordinate, for purposes of distribution, as discussed below.

11. For a comprehensive discussion of the policy considerations underlying enactment of the provisions, see John J. Slain and Homer Kripke, "The Interface between Securities Regulation and Bankruptcy" (1973) 48 NYU Law Review 261–300.

12. See for example, *Re Telegroup Inc.* (2002) 281 F 3d 133 (3rd Cir. U.S. Court of Appeals); *Re WorldCom* (2005) 329 BR 10 (Bankr. S.D.N.Y.); *Re Granite Partners LP* (1997) 208 BR 332 (Bankr. S.D.N.Y.); *Allen vs. Geneva Steel Co.* (2002) 281 F 3d 1173 (10th Cir. U.S. Court of Appeals); and *Re Pre-Press Graphics Inc.* (2004) 307 BR 65 (N.D. Ill.), which held that there must be some causal link between the purchase or sale and the claim at issue, but that the causal link need not arise contemporaneously with the sale or purchase of a security, at 78. Early cases had given a narrow interpretation to the scope of § 510(b) to claims arising from a purchase or sale of a security; see for example, *Re Amarex Inc.* (1987) 78 BR 605 (Bankr. WD Okla).

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that shareholders should bear the risk of illegality in the issuance of stock in the event that the issuer becomes insolvent.[13] In *Re Telegroup Inc.*, the U.S. Court of Appeals for the Third Circuit held that the statutory provisions were enacted "to prevent disappointed shareholders from recovering their investment losses by using fraud and other securities claims to bootstrap their way to parity with general unsecured creditors in a bankruptcy proceeding".[14] It held that the absolute priority rule reflects the different degree to which each party, securities holders and creditors, assumes the risk of enterprise insolvency and hence the subordinating provision is a risk allocation device, recognizing that shareholders assumed the risk of business failure by investing in equity rather than debt instruments.[15]

In *American Broadcasting Systems Inc.*, the U.S. Court of Appeals for the Ninth Circuit held that the two main rationales for the subordination of shareholder claims are the dissimilar risk and return expectations of shareholders and creditors, and the reliance of creditors on the equity cushion provided by shareholder investment.[16] The courts have held that nothing in the statutory language requires that a subordinated claimant be a shareholder, rather, the focus is on the type of claim possessed, hence parties that were induced to invest through misconduct still fall within the ambit of subordinated claims, as are those that hold on to securities based on misrepresentations.[17] The Tenth Circuit Court of Appeals in *Re Geneva Steel Co.* held that there is no good reason to distinguish between allocating the risks of fraud in the purchase of a security and post-investment fraud that adversely affects the ability to hold or sell; both are investment risks that the investors have assumed.[18] These judgments give a broad reading to the scope of § 510(b), specifically that claims arising from the purchase or sale of a security includes those involving post-issuance

13. *Re PT-1 Communications, Inc.* (2004) 304 BR 601 (Bankr. E.D.N.Y.); including, where the loss in value of shares was caused by a pre-purchase fraud that induced the purchase and/or a devaluing of the share due to corporate misconduct. Section 546 of the U.S. *Bankruptcy Code* provides a safe harbor for specified transactions in order to protect financial markets from the instability caused by the reversal of settled securities transactions; the proper functioning of the system, including "street-side settlement" between the brokers and the clearing agencies and "customer side settlement" between the broker and its customer, depends on guarantees of performance by all parties in the chain, *In re Enron Corp. et al vs. International Finance Corp*, interlocutory judgment by Judge Gonzalez, Case No. 01B16034 (Bankr. S.D.N.Y., 2005) at 9, citing *Jackson vs. Mishkin (In re Adler, Coleman Clearing Corp.)*, 263 B.R. 406, 476 (S.D.N.Y. 2001). The Court in *Enron* held that in enacting the § 546(e) exception to avoidance powers, the goal was to preserve the stability of settled payments and transactions (any transfer of cash or securities to complete a securities transaction) to the extent that they are not fraudulent, and where payments made for the purchase of securities were above market value, the facts as alleged in the circumstances were not sufficient to take the payments out of the realm of settlement payments commonly used in the securities industry and thus to warrant rejection of the safe harbor, *ibid.* at 10, 16.

14. *Re Telegroup Inc.* (2002) 281 F 3d 133 (3rd Cir. U.S. Court of Appeals) at 142, holding that "a claim for breach of a provision in a stock purchase agreement requiring the issuer to use its best efforts to register its stock and ensure that the stock is freely tradeable 'arises from' the purchase of stock for purposes of § 510(b) and therefore must be subordinated", and that "arising from" requires a nexus or causal relationship between the claim and the sale of the security, at 136, 138. Hence, the Court held that nothing in the underlying policy rationale of subordination would distinguish those shareholder claims predicated on post-issuance conduct from those shareholder claims based on conduct that occurred during the issuance itself, *ibid.* at 142.

15. *Ibid.* at 139.

16. *American Broadcasting Systems Inc. vs. Nugent*, U.S. Court of Appeals for the Ninth Circuit, Case Number 98-17133 (24 January 2001) at 1097 and the cases cited therein.

17. *Ibid.*

18. *Allen vs. Geneva Steel Co.* (2002) 281 F 3d 1173 (10th Cir. U.S. Court of Appeals) at 1180.

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conduct, where there is a nexus or a casual relationship between the claim and the claimant's purchase of the debtor's securities.[19]

In *re WorldCom Inc.*, an equity securities holder alleged that his claim for damages arising from ownership of WorldCom stock should not be subordinated under § 510(b) because of the scope of fraudulent and tortious conduct by which he was harmed, arguing that § 510(b) was enacted to subordinate the normal investor risk of loss, not the claims of shareholders harmed by fraud on a massive scale.[20] The Court rejected this argument, finding that the statute does not distinguish between massive frauds and petty swindles, rather, it applies even-handedly to both; and that the degree of risk accepted by investors is irrelevant because when investors purchase stock, they agree to accept a total loss, even if they do not consciously expect it, and hence the claim was subordinated.[21]

A narrow construction of § 510(b) would limit its application to claims that arise at the time of purchase or sale of shares where there was illegal conduct in the issuance of the stock.[22] The U.S. courts are not entirely settled on the scope of § 510(b), some courts declining to subordinate claims based on wrongful misconduct that arose after the issuance of shares.[23] However, as the above cases illustrate, U.S. appellate courts for the most part have subordinated such claims.

In other instances, the courts are not settled on what is to be considered an "equity claim". For example, in *Raven Media Investments LLC* vs. *DirecTV Latin America LLC*, the District Court on appeal found that the bankruptcy court had erred in subordinating Raven Media Investments' (Raven's) contract claim pursuant to § 510(b).[24] The debtor, DirecTV Latin America, provided direct-to-home satellite television in Argentina, distributed through a local operating company, Galaxy, of which the debtor owned a 49% interest. The remaining 51% of Galaxy was owned by Plataforma Digital, a wholly owned subsidiary of Grupo Clarin, Inc. Raven was also a wholly owned subsidiary of Grupo Clarin, and under a restructuring among its subsidiaries, Plataforma's interest related to DirecTV Latin America was transferred to Raven. As the result of conflicts between Raven and DirecTV Latin America regarding operation of Galaxy, the parties negotiated a strategy to terminate their joint venture whereby a purchase price was negotiated for Raven's interest, involving a stock purchase agreement with Raven acquiring a 4% interest in DirecTV Latin America in exchange for its interest in Galaxy, a put agreement and a limited liability agreement.[25] As part of these agreements, Raven was required to sign an irrevocable proxy in favor of other DirecTV Latin America members with respect to any matter requiring a super-majority vote; Raven was not restricted from pledging its interest in

19. *Re Telegroup, Inc.*, 281 F. 3d at 138.
20. *In re WorldCom, Inc.*, 329 B.R. 10 (Bankr. S.D.N.Y. 2005).
21. *Ibid.* at 13–14.
22. Zack Christensen, "The Fair Funds for Investors Provisions of *Sarbanes-Oxley:* Is it Unfair to the Creditors of a Bankrupt Debtor?" (2005) University of Illinois L. Rev 339 at 361, citing *Re Telegroup, Inc.*, 281 F. 3d at 135; and *In re Montgomery Ward Holding Corp.* 272 B.R. 836 (Bankr. D. Del. 2001).
23. See for example, *Re Montgomery Ward Holding Corporation* 272 BR 836 (Bankr. D. el. 2001); *Re Amarex Inc.* 78 BR 605 (W.D. Oak. 1987).
24. *Raven Media Investments LLC. vs. DirecTV Latin America, LLC.* (2004) No. Civ. 03-981-SLR, 2004 WL 302303 (D. Del.).
25. *Ibid.* at 2–3.

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DirecTV Latin America; it was not to receive notice of meetings; was not consulted in any manner relating to the company's affairs and held no obligation to make capital contributions. Raven held a contract claim under the put agreement in the amount of U.S. $169 million exclusive of interest.[26]

The Court held that § 510(b) did not apply to subordinate Raven's contractual claims on the basis that Raven did not seek to hold an equity interest in DirecTV Latin America; the transaction was structured to exclude Raven's participation in management; the interest apportioned was on an arbitrary value not a valuation of the debtor; Raven was excluded from any required capital contributions; and it was not informed of the business affairs of the debtor or the exercise of its proxy. The Court held that these were not conditions consistent with the purchase of equity and the transaction was structured so that Raven would not bear the risk of illiquidity or insolvency; hence while Raven held equity in name, it possessed few characteristics associated with that status. The Court distinguished *Telegroup* in that the stock purchase agreement was structured such that Raven did not bear any risk and was allocated a specified contract price in the event of a breach, the Court finding that this price was important in light of the bootstrapping intent of the statutory provision.[27] The Court concluded that the purpose of § 510(b) was not served by imposing the risk of business failure on a party that unequivocally did not contract for it. Hence, the Court distinguished the nature of the interest in declining to subordinate the claim.

A number of U.S. scholars have been critical of the public policy reasons underlying mandatory subordination, distinguishing between risk assumed by investors for business investment and the non-assumption of risk in respect of fraudulent conduct on the part of the debtor corporation.[28] For example, Kevin Davis observes that since the subordination theory of creditor reliance was developed in the U.S., the nature of both debt and equity investment has changed; the majority of shareholders are no longer a small group of entrepreneurs; rather, they are a broadly dispersed group that cannot easily monitor officer conduct. Creditors frequently include large sophisticated financial institutions that are able to monitor the activities of corporate officers through disclosure and other covenants, and for the most part no longer include only small vulnerable trade suppliers. Hence, the comparative ability of debt and equity classes to protect themselves from fraud has shifted.[29] He suggests that the appropriate response is to compensate shareholders for fraud loss but not business loss, thus preventing after-the-fact renunciation of risk.[30] A counter-point to Davis' argument is that it is the equity investors, not the creditors that vote for the directors, who in turn select the corporate officers; and arguably, shareholders need to at least attempt to organize themselves to be effective monitors of corporate officer conduct. However, this suggestion may not be realistic, given the small proportion of

26. *Ibid.* at 5.
27. *Ibid.*; *Official Committee of Unsecured Creditors vs. American Capital Financial Services, Inc.* (*In re Mobile Tool International, Inc.*) 306 B.R. 778 (Bankr. D. Del. 2004).
28. See for example, Kevin B. Davis, "The Status of Defrauded Securityholders in Corporate Bankruptcy" (1983) Duke L.J. 1; Robert Stark, "Reexamining the Subordination of Investor Fraud Claims in Bankruptcy: A Critical Study of *In re Granite Partners*" (1998) 72 Am. Bankr. L.J. 497.
29. *Ibid.* at 29.
30. *Ibid.* at 41.

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shareholdings that most investors have at risk. Moreover, there is a further shift in the nature of corporate debt, with financial institutions such as banks generally holding less corporate debt and hedge funds that have varying monitoring capacities holding more corporate debt.

The U.S. *Bankruptcy Code* also authorizes the court, under the principles of equitable subordination, to subordinate for the purposes of distribution of all or part of an allowed claim or interest.[31] The courts have held that they will look to the nature and substance of the claim and not the form, and that there are three prerequisites: the claimant must have engaged in some type of inequitable conduct; the misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and equitable subordination of the claim must not be inconsistent with the provisions of the *Bankruptcy Code*.[32] As a general rule, courts prefer the claims of innocent unsecured creditors over the claims of shareholders deceived by officers of the corporation; however, in the case of stock redemption, the courts look at the substance of the transaction, in deciding to subordinate equitably the claims of a former shareholder turned creditor to the claims of general unsecured creditors.[33]

Hence, while there is clearly statutory language subordinating equity claims in the U.S., the debate regarding the scope of that subordination is not entirely settled. Moreover, new remedies available to investors through the enforcement activities of securities regulators have altered the absolute subordination regime, as discussed in the next part.

B. Tensions in the allocation of risk: *Sarbanes-Oxley's* fair funds for investors provision and subordination of claims under the U.S. *Bankruptcy Code*

U.S. securities law has provided for civil remedies for claims of misrepresentation, fraudulent conduct, and other violations of securities laws for a number of years. As a consequence, there have been a number of class actions against corporations, which either precipitate firms filing U.S. *Bankruptcy Code* Chapter 11 proceedings or liquidation proceedings, or that arise once the conduct of officers becomes known in a bankruptcy proceeding. The vast majority of these cases settle before judgment. While the claims under the settlement are subordinated under U.S. bankruptcy law, remedies under the *Sarbanes-Oxley Act of 2002* have given rise to new indirect remedies to equity investors for

31. Section 510(c), U.S. *Bankruptcy Code*. Under § 510(c) of the U.S. *Bankruptcy Code*, the court retains a power under the principles of equitable subordination, to exercise its authority to subordinate, for purposes of distribution, all or part of an allowed claim or interest to all or part of another allowed interest.

32. *In re Mobile Steel Co.*, 563 F. 2d 692 (5th Cir. 1977); *In re Structurlite Plastics Corporation*, 224 B.R. 27; 1998 Bankr. LEXIS 1038, 1998 FED App. 0015P (6th Cir.). However, Christensen has observed that some courts have held that inequitable conduct on the part of the claimant is not always a necessary element for a remedy of equitable subordination; Christensen, *supra*, note 22 at 374.

33. *In re Structurlite Plastics Corporation*, *ibid.* at 12; in which a creditor and an unsecured creditors' committee of the debtor filed an action against the former shareholders of the debtor in a failed LBO. The debtor had borrowed money and then loaned it to the purchaser so that the purchaser could pay the former shareholders. On appeal of the summary judgment granted in favor of the creditor and the unsecured creditors' committee, the Court held that the creditor and the unsecured creditors' committee had standing to assert the fraudulent conveyance claims under 11 U.S.C.S. § 544(b) and Ohio Rev. Code Ann. § 1336.04 (repealed 1990). The Court held that the bankruptcy court's subordination of the former shareholders' claims to the claims of general unsecured creditors was not an error.

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harms caused by securities law violations. The *Sarbanes-Oxley Act* was enacted in response to corporate scandals and considerable public pressure to respond to the harms caused by massive frauds perpetrated by U.S. companies. It represents the particular nature of U.S. democracy in that it was a rapid response to severely shaken markets and the result of intense lobbying to address the weaknesses in U.S. securities law and the consequent harms.

In the U.S., the subordination of equity claims has been tempered in the case of securities fraud by the ability of investors to receive compensation under powers granted to the Securities Exchange Commission (SEC) under the *Sarbanes-Oxley Act*. The SEC is given express power to distribute payments to investors as part of the "fair funds for investors" civil penalty and disgorgement powers.[34] The fair funds provisions have been successfully used to return at least some of the losses to investors. In 2005, $1.9 billion in disgorgement and penalties was ordered, 96% of which was collected; in 2006, $1.2 billion was ordered, 82% of which was collected.[35] While many cases do not involve bankruptcy proceedings, a number do.

Section 308(a) of the *Sarbanes-Oxley Act* allows civil penalties to be added to disgorgement funds for the relief of victims of securities fraud, allowing the SEC to distribute both the civil penalties and disgorgement funds created under the *Sarbanes-Oxley Act* from the assets of the bankruptcy estate to investors.[36] SEC claims rank equally with those of unsecured creditors in a bankruptcy or reorganization proceeding. Previously, civil penalties could only be paid to the U.S. Treasury. The fair funds provision allows investors wronged by securities law violations to recover at least a portion of their losses from the fraudulent conduct of the debtor by route of the SEC's lawsuit against the debtor corporation.[37] Hence, while a shareholder's claim is subordinated pursuant to § 510(b) of the U.S. *Bankruptcy Code*, the investor may be eligible for a distribution pursuant to the fair funds for investors provision under the *Sarbanes-Oxley Act* from the bankrupt's assets indirectly through the SEC. Arguably, this eligibility creates a tension in reconciling the public policy objectives of these two statutes.[38]

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34. *Sarbanes-Oxley Act of* 2002, Pub. L. No. 107–204, 116 Stat. 745, codified in Titles 11, 15, 18, 28, and 29 U.S.C. (2002) at section 308. For a discussion, see Christensen, *supra*, note 23; Marvin Sprouse and Jackson Walker, "A Collision of Fairness: *Sarbanes-Oxley* and § 510(b) of the *Bankruptcy Code*" (2005) 24 American Bankruptcy Institute Journal 8.

35. Christensen, *ibid.* at 56. Compensation to investors is a secondary function and the primary objective of the provisions is deterrence. The SEC also has authority to impose civil penalties in the same action, based on the degree of inappropriate conduct, however, these penalties are not available to investors as compensation for harms caused by the bankrupt's conduct.

36. Section 308(a) specifies: "If in any judicial or administrative action brought by the Commission under the securities laws (as such term is defined in § 3(a)(47) of the *Securities Exchange Act of 1934* (15 U.S.C. 78(c)(a)(47)) the Commission obtains an order requiring disgorgement against any person for a violation of such laws or the rules or regulations thereunder, or such person agrees in settlement of any such action to such disgorgement, and the Commission also obtains pursuant to such laws a civil penalty against such person, the amount of civil penalty shall, on the motion or at the direction of the Commission, be added to and become part of the disgorgement fund for the benefit of the victims of such violation".

37. See for example, *S.E.C. vs. Lybrand*, 281 F. Supp. 2d 726 (S.D.N.Y. 2003) at 727; *S.E.C. vs. Giesecke*, Accounting and Auditing Enforcement Release No. 1636 (25 September 2002).

38. The SEC already has had the ability under the U.S. *Bankruptcy Code* to enforce securities law even if the debtor was in bankruptcy proceedings, although the statute prohibits it from enforcing a money judgment outside of the bankruptcy proceedings and recovery of the penalty amounts may only occur through the final bankruptcy distribution. This exemption from the usual stay provisions recognizes the public policy underpinning securities law enforcement activities; section 362(b), *Bankruptcy Code*.

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The fair funds provision was enacted as further recognition of the SEC's authority to create equitable remedies, including disgorgement orders that obligate the surrender of profits and interest acquired in violation of securities law.[39] The provision allows the SEC to enhance its enforcement of securities law and to seek remedies that will serve as a deterrent to fraudulent conduct by issuing corporations. The amount of civil liability that the SEC will seek to impose depends on the egregiousness of the issuer's conduct, the degree of its scienter, whether the conduct created substantial losses or risk of losses to others, whether the conduct was of a recurring nature, and the debtor's current and anticipated financial condition.[40] The SEC may seek orders requiring parties to disgorge any money obtained through wrongdoing and is empowered to seek civil penalties for violations of securities laws.[41] Disgorgement is an equitable remedy that requires the corporation or party that engaged in fraudulent activities to give up the amounts by which they were unjustly enriched by the wrongful conduct. While the SEC bears the burden of proving that the amount sought is appropriate, the courts have held that the amount of disgorgement need only be "a reasonable approximation of profits causally connected to the violation".[42]

In a bankruptcy proceeding, the SEC's civil action is frequently settled and in such cases, the court must approve the settlement. The court determines whether the proposed settlement is fair and equitable and in the best interests of the estate, and the court must be assured that it does not fall below a range of reasonableness. Where the SEC has received a judgment for civil penalties and disgorgement, either on a settlement basis or after litigation, the amount ordered by the court is the SEC's claim against the estate of the debtor corporation and it ranks with ordinary creditors, above equity claimants. Under Chapter 11 *Bankruptcy Code* proceedings, the debtor is discharged from the SEC's monetary penalty on confirmation of a plan of reorganization; however, the debtor must pay the SEC a percentage of the penalty equal to the percentage received by unsecured creditors under the reorganization plan.

The fair funds provision allows the SEC to provide restitution to defrauded shareholders. Where appropriate, the SEC has returned disgorged funds to harmed investors and, as a result of the fair funds provision of the *Sarbanes-Oxley Act*, has used amounts paid as penalties to reduce losses to injured parties.[43] Hence, funds that previously were realized and went to the U.S. treasury are now available through the disgorgement fund to be distributed to investors who were harmed by the fraudulent conduct of the debtor corporation.

In *SEC v. WorldCom*, the Southern District of New York Court approved a settlement where WorldCom had engaged in a massive accounting fraud of more than U.S. $3

39. SEC, *2006 Performance and Accountability Report* http://www.sec.gov/about/secpar/secpar2006.pdf at 56.
40. *S.E.C. vs. Kane*, 2003 U.S. Dist. LEXIS 5043 (S.D.N.Y. 2002) at 11; *S.E.C. vs. Credit Bancorp, Ltd.*, 2002 U.S. Dist. LEXIS 20597 (S.D.N.Y. 2002) at 9.
41. SEC, *2006 Performance and Accountability Report, supra*, note 39 at 56.
42. *S.E.C. vs. Patel*, 61 F. 3d 137, 139 (2d Cir. 1995).
43. SEC, *2006 Performance and Accountability Report, supra*, note 39 at 56. Funds not returned to investors are sent to the treasury.

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billion.[44] The SEC action had been filed almost 1 month before WorldCom filed for Chapter 11 protection and the SEC action and the Chapter 11 proceeding were being conducted concurrently.[45] Settlement of the case involved two rulings. The first ruling was injunctive relief, including review of WorldCom's corporate governance systems and accounting policies and controls, with education to reduce risk of further violations.[46] In the second ruling, the SEC secured an injunction against WorldCom and proposed a settlement agreement whereby the SEC would impose a U.S. $2.25 billion monetary penalty (40% of the estimated liquidation value of WorldCom), which would be satisfied by a U.S. $750 million payment from the bankruptcy estate, comprised of U.S. $500 million cash payment and U.S. $250 million in the reorganized company's common stock. The Court held that the amount was aimed at ensuring that there was sufficient penalty to deter the officers from future fraudulent conduct while also ensuring that the corporation was able to reorganize.[47] The settlement expressly provided that the settlement assets would be directed to defrauded shareholders pursuant to the fair funds for investors provision of *Sarbanes-Oxley*. In approving the settlement, Judge Rakoff observed that the SEC had authority to seek a civil penalty for the full value derived from WorldCom's fraud, an estimated U.S. $10–17 billion and that a penalty of that magnitude would necessarily destroy the company to the detriment of some 50 000 innocent employees.[48]

The Court in *WorldCom* recognized the potential conflict between the fair funds for investors provision of the *Sarbanes-Oxley Act* and the U.S. *Bankruptcy Code*, observing that a civil penalty imposed by the SEC premised primarily on compensating defrauded shareholders might arguably run afoul of the provisions of the *Bankruptcy Code* that subordinate shareholder claims below all others. The Court held that compensation is a secondary goal to deterrence, but that the SEC could rationally take account of shareholder loss as a relevant factor in formulating the size and nature of the penalty and it could distribute the settlement amount from civil penalties to investors.[49] In the bankruptcy proceedings of WorldCom, Judge Gonzalez approved the settlement with the SEC pursuant to Federal Rule of Bankruptcy Procedure 9019, based on the creditors' committee support for the settlement, the risk of an even greater penalty if the amount were litigated to judgment, and the uncertainty in the priority issue as between the two statutory regimes. While noting the apparent conflict between the two statutes, the Court held that "in considering approval of a settlement, the court is not required to resolve the underlying legal issues related to

44. *SEC vs. WorldCom* 273 F. Supp. 2d 431 (S.D.N.Y. 2003).

45. The SEC commenced the civil action on 26 June 2002 in the U.S. District Court for the Southern District of New York against WorldCom alleging massive accounting fraud and WorldCom filed for Chapter 11 protection on 21 July 2002, given the size of the SEC's claims.

46. David Henry, "Subordinating Subordination: WorldCom and the Effect of *Sarbanes-Oxley's* Fair Funds Provision on Distributions in Bankruptcy" (2004) 21 Emory Bankruptcy Developments Journal 259 at 294.

47. *SEC vs. WorldCom* 273 F. Supp. 2d 431 (S.D.N.Y. 2003) at 435. The settlement amount was 75 times greater than any prior penalty for accounting fraud.

48. *Ibid.*

49. *Ibid.*

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the settlement" and it did not "fall below the lowest point in the range of reasonableness".[50] The Court held that the SEC had taken adequate account of the magnitude of the fraud and the need for deterrence, while fairly and reasonably reflecting the realities of a complex situation.[51]

Thus in *WorldCom*, while the court was not required to determine the conflict between the two statutes, it did recognize the tension and balanced the interests at stake in finding the settlement appropriate. The outcome is that shareholders realized some value on their losses indirectly through the SEC's action.

In *Adelphia*, the SEC asserted claims for disgorgement of profits and for civil penalties based on fraud and accounting irregularities.[52] The bankruptcy court was asked to endorse a comprehensive settlement proposal that would require Adelphia to contribute U.S. $715 million to a restitution fund in exchange for the Department of Justice not instituting criminal action and the SEC dropping its claims against the corporation and its subsidiaries. Although creditors objected to the proposed settlement based on an alleged violation of the absolute priority rule, the Court held that § 510(b) did not prohibit the settlement since shareholders would not be sharing in the assets of the estate under a plan, but rather sharing in a fund created and owned by the government, and that the subordination provision does not apply to assets belonging to the government.[53] While defrauded equity holders would have to confront the absolute priority rule and § 510(b) when trying to share in the assets, that issue was far removed from the request to approve the settlement.[54] The Court approved the settlement on the basis that it was reasonable.

The outcome of these judgments has been contested. Sprouse and Walker have observed that in most cases the claims of shareholders are at the lowest end of the distributive priority spectrum established by the *Code*, arguing that if the SEC is able to fund the fair fund for investors program with civil penalties imposed on a bankruptcy estate for the benefit of interest-holders, such action runs afoul of § 726(a)(4), depending on whether an SEC penalty is characterized as "compensation for actual pecuniary loss". They observe that § 726(a)(4) is operative in the Chapter 11 context in that a plan may not be approved over the objection of an impaired class of claims or interests if the creditors in that class are to receive less than a liquidation distribution.[55]

However, David Henry has suggested that the court's application of the fair funds provision is correct, and while it may be contrary to the theory underlying the absolute

50. *S.E.C. vs. WorldCom Inc.*, 273 F. Supp.2d 431 (S.D.N.Y. 2003) at 435; *In re WorldCom Inc.*, Ch. 11 Case No. 02-13533, Docket # 8125 (Bankr. S.D.N.Y. 6 August 2003). *S.E.C. vs. WorldCom Inc.*, Litigation Release No. 17588 (Civil Action 02 CV 4963 (S.D.N.Y.) (27 June 2002)), available at www.sec.gov/litigation/litreleases/lr17588.htm.

51. *S.E.C. vs. WorldCom Inc.*, 273 F. Supp.2d 431 (S.D.N.Y. 2003) at 436.

52. *In re Adelphia Communications Corp.*, 327 B.R. 143, 149 (Bankr. S.D.N.Y. 2005).

53. The Court held that the settlement was proposed pursuant to Federal Rule of Bankruptcy Procedure, *ibid.*

54. *Ibid.* at 169.

55. Sprouse and Walker, *supra*, note 34 at 12, citing *In re WorldCom Inc.*, Ch. 11 Case No. 02-13533 (Bankr. S.D.N.Y. 21 July 2002 (petition date)); *In re Adelphia Communications Corp.*, Chapter 11 Case No. 02-41729 (Bankr. S.D.N.Y. 25 June 2002 (petition date)). They also note that: "in a chapter 7 case, §726(a)(4) of the *Code* provides that distributions of estate property for allowed claims based on fines or penalties that are 'not compensation for actual pecuniary loss" hold a lower distributive priority vis-a-vis allowed general unsecured claims'.

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priority rule and subordination of shareholder claims, it is a proper application of securities law and treatment of funds arising from securities law fraud claims; and that this recognition of the importance of securities law enforcement allows shareholders to recover losses from fraud on a *pari passu* basis with the claims of unsecured creditors.[56] He also observes that the absolute priority rule is often ignored in bankruptcy proceedings in order to allow parties the flexibility of shifting assets to those most deserving and hence it is not really a justification for refusing to recognize shareholder claims in specified circumstances. Henry suggests that the fair funds provisions is an expression of Congress' objective of ensuring that at least some portion of penalties realized on securities fraud is available for distribution to wronged investors.[57] Moreover, he argues that while shareholders may agree to ordinary risk of business loss from their investment, they are not agreeing to assume the extraordinary risk of business fraud loss; and that both creditors and investors are limited in their ability to monitor against fraudulent activities and both should share in the risk.[58]

In sum, subordination of equity claims and § 510(b) of the U.S. *Bankruptcy Code* has been tempered by the *Sarbanes-Oxley* fair funds provision.[59] While equity investors continue to have their right to distributions of their shares subordinated under ordinary business risk principles, the fair funds process creates a public policy mechanism aimed at deterring corporate misconduct and at allocating proceeds recovered from such harms to those harmed through distribution of disgorgement and civil penalties funds. This mechanism of indirect redress for harms is distinguishable from granting equity investors direct remedies for harms arising out of statutory violations during insolvency proceedings, which is not a public policy choice that the U.S. has made. The fact that investors realize only through the enforcement activities of the SEC means that the SEC acts in a gatekeeping role in respect of these claims, addressing the arguments that equity investors would somehow use securities claims to bootstrap their position on liquidation. The SEC's primary function in seeking disgorgement and civil penalties is the deterrence objective. While secondary, compensation to investors does appear to have assisted in meeting the public policy goals of securities laws, while continuing to observe the public policy goals of insolvency law. One issue that deserves further examination is precisely how disgorgement from the company creates a deterrent effect on corporate officers, unless their own personal wealth is also disgorged where they have engaged in fraud. While arguably there are reputational losses and sometimes criminal sanctions, it would seem that financial forfeiture of personal gains from misconduct would be an effective way in which future misconduct by these or other officers is discouraged.

C. The treatment of equity claims in Canada

In Canada, there is not yet express statutory language regarding equity claims in either the *Bankruptcy and Insolvency Act* or the *Companies' Creditors Arrangement Act*

56. Henry, supra, note 46 at 297.
57. *Ibid.*
58. *Ibid.* at 299.
59. The absolute priority rule does not subordinate shareholder claims, but rather, applies only to distributions to shareholders on their shares, not to any damages claims, which is why 510(b) was enacted.

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(*CCAA*); and equity claims have been subordinated to creditor claims under general corporate law and common law principles.[60] Equity investors are not entitled to share in the assets of an insolvent corporation until after all the ordinary creditors have been paid in full.[61] The courts will consider the true nature of a transaction and the surrounding circumstances to determine whether a claim is a claim provable in bankruptcy or restructuring proceedings, specifically, whether the true nature of the relationship is that of an equity investor or a creditor owed a debt.[62] In the context of restructuring proceedings, Canadian courts have held that where there is no equity value left in the debtor corporation, shareholders will not be allowed to hinder the wishes of creditors as to the outcome of the proceeding.[63] In *Re Canadian Airlines Corp.*, the Court held that where a corporation is insolvent, on liquidation the shareholders would get nothing, and that in such circumstances, there is nothing unfair or unreasonable in the court approving a restructuring plan without shareholder approval, as it would be unfair to the creditors and other stakeholders to permit the shareholders, whose interest has the lowest priority, to have any ability to block a reorganization.[64]

The underlying policy rationale is that shareholders are at the bottom of the hierarchy of claims during an insolvency or bankruptcy proceeding and where there is not sufficient value to meet the claims of unsecured creditors, there is clearly no residual value for equity claims and hence they should not be given a vote in the proceedings.[65] While courts will consider the interests of equity investors along with other stakeholders such as employees, trade suppliers, and local communities that are dependent on the economic activity of the debtor corporation, this is a public interest

60. *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36, as amended (*CCAA*). *Re Central Capital Corporation* (1996), 132 D.L.R. (4th) 223 (Ont. C.A.) at 245; *Canada Deposit Insurance Corp.* vs. *Canadian Commercial Bank* (1992), 97 D.L.R. (4th) 385 (S.C.C.) at 402–408.

61. *Re Royal Oak Mines Inc.* (1999), 14 C.B.R. (4th) 279 (Ont. S.C.J. (Commercial List)); *Re Central Capital Corporation, ibid.* at 245. For example, s. 211(7) of the *Canada Business Corporations Act* (*CBCA*) R.S.C. 1985, c. C-44, as amended, specifies that when a corporation intends to liquidate, the corporation is to send notice to creditors; proceed to collect its property and discharge all its obligations and to do all other acts required to liquidate its business; and after adequately providing for the payment or discharge of all its obligations, distribute its remaining property, either in money or in kind, among its shareholders according to their respective rights, codifying the hierarchy of claims on liquidation.

62. *Canada Deposit Insurance Corp. vs. Canadian Commercial Bank* (1992), 97 D.L.R. (4th) 385 (S.C.C.) at 402, 406, 408. In *Canada Deposit Insurance,* the Supreme Court of Canada held that emergency financial assistance provided to the Canadian Commercial Bank by a group of lending institutions and government was properly categorized a loan for the purpose of determining whether the group was entitled to rank *pari passu* with unsecured creditors in an insolvency. The Court found that the arrangement was hybrid in nature, combining elements of both debt and equity, it was in substance a loan and not a capital investment as the equity component of the arrangement was incidental and had never come into effect, and the parties' agreements supported the characterization of the arrangement as a loan. See also *National Bank of Canada* vs. *Merit Energy Ltd.*, 2001 CarswellAlta 913 (Alta. Q.B.).

63. *Re Canadian Airlines Inc* (2000) A.J. No. 771 (2000), 9 B.L.R. (3d) 41 (Alta Q.B.) at 76; *Re Loewen Group Inc.* (2001), 22 B.L.R. (3d) 134 (Ont. S.C.J. (Commercial List); *Fiber Connections Inc.* (2005), 5 B.L.R. (4th) 271; Janis P. Sarra, *Rescue! The Companies' Creditors Arrangement Act* (Toronto: Carswell, 2007).

64. *Re Canadian Airlines Inc., ibid.* at para. 76.

65. Courts have relied on corporate law provisions. For example, section 191(1) of the *Canada Business Corporations Act* R.S.C. 1985, c. C-44, as amended, (*CBCA*) defines reorganization to include a court order under the *BIA* approving a proposal or any other statute that affects the rights among the corporation, its shareholders and creditors. It grants the court authority to make orders approving reorganizations, including authorize the issue of debt obligations of the corporation, whether or not convertible into shares of any class or having attached any rights or options to acquire shares of any class, and fix the terms thereof; s. 191(3), *CBCA*. *Re Canadian Airlines Inc., ibid.; Re T. Eaton Co.* (1999) O.J. No. 5322 (Ont. S.C.J. (Commercial List)).

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consideration as opposed to recognizing equity claims as having a determinative status.[66] Where, however, there is still equity value remaining, either in the form of going forward equity or in the tax losses associated with the insolvency, shareholders may be given a vote in a restructuring proceeding.[67]

In *Re Central Capital Corporation*, the Ontario Court of Appeal observed that holding that the appellants do not have provable claims accords with sound corporate policy and that on insolvency, the claims of creditors rank ahead of the claims of shareholders for the return of their capital. Case law and statute law protect creditors by preventing companies from using their funds to prejudice creditors' chances of repayment, given that creditors rely on these protections in making loans to companies.[68] In *Central Capital Corporation*, the Court of Appeal held that a relationship between preferred shareholders and the corporation had the characteristics of both debt and equity; however, in substance, the preferred shareholders were shareholders and the existence of retraction rights did not change them into creditors. The Court held that the preferred shareholders had agreed to take preferred shares instead of another type of instrument, such as a bond or a debenture, and there was no evidence to support their contention that by taking the preferred shares they were extending credit to the debtor corporation; moreover, their interest was listed as capital on the company's financial statements.[69] Thus, the Court determined the case on the nature of the relationship.

Currently, Canadian legislation is not completely silent on the treatment of equity claims.[70] Under most Canadian corporations statutes, a plan of reorganization or

66. For a discussion, see Janis Sarra, *Creditor Rights and the Public Interest, Restructuring Insolvency Corporations* (Toronto: University of Toronto, 2002).

67. *Re T. Eaton Co.* (1999) O.J. No. 5322 (Ont. S.C.J. (Commercial List)) where the Court noted at para. 10 treatment of shareholder claims in several cases: "I think it appropriate to note that in Sammi Atlas, the shareholder got $1.25 million U.S.; in Cadillac Fairview Inc. nothing; and in Royal Oak it is proposed the shareholders be diluted down to 1% equity interest underneath a heavy blanket of other obligations. When viewed in contrast, the Eaton's deal would appear to be on the rich side". The Court took into consideration the fact that both classes of creditors as well as the shareholders voted overwhelmingly in favor of the Eaton's Plan, the unsecured creditors were 99% in support and the shareholders 99.5% in support, at para. 7. In approving a plan under the *CCAA* and in exercising its discretion to approve an arrangement under the Ontario *Business Corporations Act*, the Court in Eaton held that it must be satisfied that the arrangement meets the same criteria as set out above for approving a plan under the *CCAA*, specifically, the fairness and reasonableness of a plan. The Court held that it does not require perfection; nor will the court second guess the business decisions reached by the stakeholders as a body. The Court observed that many of the shareholders have suffered significant losses as a result of the demise of Eaton's, however, it held that it was important for at least future situations that in devising and considering plans persons recognize that there is a natural and legal "hierarchy of interest to receive value in a liquidation or liquidation-related transaction" and that in that hierarchy the shareholders are at the bottom. However, in the circumstances here prevailing, the Court held that the plan was fair and reasonable.

68. *Re Central Capital Corporation* (appeal judgment), *supra*, note 60, concurring opinion of Laskin, JA, at 274.

69. Under the Canada *Business Corporations Act*, an insolvent corporation is prohibited from redeeming shares and hence the shareholders had no right to enforce payment.

70. The *BIA* currently distinguishes claims made under transactions that seek repayment in the form of profits. Section 139 of the *BIA* specifies that where a lender advances money to a borrower engaged or about to engage in trade or business under a contract that the lender is to receive a rate of interest varying with profit or a share of profits, the lender is not entitled to any payment in respect of the loan until the claims of all other creditors have been satisfied. Essentially, the lender is considered a silent partner for purposes of the provisions. However, if the lender holds security for its claim, it is entitled to enforce it L. Houlden, G. Morawetz, and J. Sarra, *The 2007 Annotated Bankruptcy and Insolvency Act* (Toronto: Carswell, 2006) at 668; *Sukloff vs. A.H. Rushforth & Co.* (1964), 6 C.B.R. (N.S.) 175 (S.C.C.). Where shareholders lent money to a debtor but did not receive a rate of interest varying with profit or sharing profits, subordination has been found not to apply: *Re Provost Shoe Shops Ltd.* (1993), 21 C.B.R. (3d) 108, 340 A.P.R. 302 (S.C.).

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plan of arrangement can restructure equity without a shareholder vote if the equity investment has no value.[71] These provisions come into play where there is a condition of insolvency.

In the context of restructuring proceedings, Canadian courts have held that where shareholder interests are "under water" or "below the Plimsoll line", that is, that there is no equity value left in the debtor corporation, shareholders will not be allowed to vote on a restructuring plan or a proposal and will not be allowed to hinder the wishes of creditors as to the outcome of the proceeding or the specific proposal or plan of arrangement and compromise.[72] In a corporate plan of arrangement or reorganization, the court has authority to do by order something that usually requires a shareholder vote, and the court can decide whether or not to exercise its authority to make such an order.[73] Unlike a Chapter 11 debtor in the U.S., a Canadian debtor corporation must meet an insolvency test before it can have access to insolvency legislation; hence the interests of equity investors are most often already under water at the point that the debtor filings insolvency proceedings.

Re Blue Range Resource Corp. was the first Canadian case that dealt directly with the issue of whether an equity investor in a takeover bid, allegedly induced by fraud to purchase shares of a debtor corporation, was able to assert its claim in such a way as to achieve parity with other unsecured creditors in a *CCAA* proceeding.[74] The Alberta Court of Queen's Bench considered the treatment of shareholder claims for negligent misrepresentation, addressing the question of whether the treatment of such claims differed from the risks of ordinary business investments.[75] *Blue Range* involved an application for determination of whether Big Bear Exploration Ltd.'s claim should rank equally with claims of unsecured creditors. Big Bear had succeeded in a takeover bid for Blue Range Resource Corp. by way of exchange of shares and claimed that its decision to undertake the takeover was made in reliance on information publicly disclosed by Blue Range regarding its financial situation. After the takeover, it discovered that the information disclosed by Blue Range was misleading and that the

71. Where a corporation is insolvent, defined in s. 192 (2) of the *CBCA* as where it is unable to pay its liabilities as they become due; or where the realizable value of the assets of the corporation are less than the aggregate of its liabilities and stated capital of all classes, where it is not practicable for a corporation that is not insolvent to effect a fundamental change in the nature of an arrangement under any other provision of this Act, the corporation may apply to a court for an order approving an arrangement proposed by the corporation; s. 192 (3), *CBCA*. The court has the authority under s. 192 to may make any interim or final order it thinks fit including, dispensing with notice requirements, appointing representative counsel, an order requiring a corporation to call, hold, and conduct a meeting of holders of securities or options or rights to acquire securities in such manner as the court directs; an order permitting a shareholder to dissent under section 190; and an order approving an arrangement as proposed by the corporation or as amended in any manner the court may direct.

72. See for example, *Re Canadian Airlines Inc.* (2000), 9 B.L.R. (3d) 41 (Alta Q.B.) at 76; *Re Loewen Group Inc.* (2001), 22 B.L.R. (3d) 134 (Ont. S.C.J. (Commercial List); *Fiber Connections Inc.* (2005), 5 B.L.R. (4th) 271; Janis P. Sarra, *Rescue! The Companies' Creditors Arrangement Act* (Toronto: Carswell, 2007).

73. In *Re T. Eaton Co.* (1999) O.J. No. 5322 (Ont. S.C.J. (Commercial List)), the Court held at para. 2 that: "In exercising its discretion to approve an arrangement under the Ontario *Business Corporations Act* (OBCA), the court must be satisfied that the arrangement meets the same criteria as set out above for approving a plan under the *CCAA*". See also Olympia & York Developments Ltd. (1993) 18 C.B.R. (3d) 176 (Ont. Gen. Div.) at 186.

74. *Re Blue Range Resource Corp.*, 2000 Carswell Alta 12, 15 C.B.R. (4th) 169 (Alta Q.B.).

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

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Blue Range shares were essentially worthless. As sole shareholder, Big Bear caused the company to apply for protection under the *CCAA*.[76]

The first issue was whether Big Bear's claim was as an unsecured creditor of Blue Range that ranked equally with the unsecured creditors or whether its claim was as a shareholder of Blue Range that ranked after the unsecured creditors.[77] The Court held that the nature of Big Bear's claim against Blue Range for an alleged share exchange loss, transaction costs, and cash share purchase damages was in substance a claim by a shareholder for a return of what it invested *qua* shareholder, and hence the claim ranked after the claims of unsecured creditors.[78]

The Court held that the very core of the claim was the acquisition of Blue Range shares by Big Bear and whether the consideration paid for such shares was based on misrepresentation. It held that Big Bear had no cause of action until it acquired shares of Blue Range, which it did through share purchases for cash prior to becoming a majority shareholder. The Court concluded that the tort claim derived from Big Bear's status as a shareholder, and not from a tort unrelated to that status.[79] The claim for misrepresentation was hybrid in nature and combined elements of both a claim in tort and a claim as shareholder, and hence the Court observed that it must determine what character it had in substance. The Court found that it was not a claim for return of capital in the direct sense; rather, it was a claim for an award of damages measured as the difference between the "true" value of Blue Range shares and their "misrepresented" value, "in other words, money back from what Big Bear 'paid' by way of consideration".[80] The Court held that a tort award to Big Bear could only represent a return of what Big Bear invested in equity of Blue Range and that it is that kind of return that is limited by the basic corporate law principle that shareholders rank after creditors in respect of any return on their equity investment. It observed that Big Bear acquired not only rights but also restrictions under corporate law when it acquired the Blue Range shares. The Court found that the alleged share exchange loss derived from and was inextricably intertwined with Big Bear's shareholder interest in Blue Range, and thus that the nature of the claim was in substance a claim by a shareholder for a return of what it invested as shareholder, rather than an ordinary tort claim.[81]

The Court held that it was clear that in common law shareholders are not entitled to share in the assets of an insolvent corporation until after all the ordinary creditors

76. Big Bear, as the sole shareholder of Blue Range, entered into a Unanimous Shareholders' Agreement (USA) pursuant to which Big Bear replaced and took on all the rights, duties and obligations of the Blue Range directors and using its authority under the USA, Big Bear caused Blue Range to apply for protection under the *CCAA; Re Blue Range Resource Corp. ibid.* Big Bear made an unsecured claim for the value of shares exchanged in the takeover bid, pursuing the claims through two different routes: by filing notice of claim for damages for share exchange loss, and filing a statement of claim alleging other causes of action. The Alberta court made orders that precluded Big Bear from advancing claims beyond those set out in notice of claim and Big Bear sought an expedited trial for hearing the claim.

77. *Ibid.* The applicants were the Creditors' Committee of Blue Range and Enron Canada Corp., a major creditor.

78. 14.

79. *Ibid.* at para. 22.

80. *Ibid.* The Court held that while the matter was complicated by reason that the consideration paid for Blue Range shares by Big Bear was Big Bear treasury shares, the notice of claim quantified the loss by assigning a value to the treasury shares.

81. *Ibid.* at para. 25.

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have been paid in full.[82] In that sense, Big Bear acquired not only rights but also restrictions under corporate law when it acquired the Blue Range shares. The Court relied on the fundamental corporate principle that claims of shareholders should rank below those of creditors on insolvency, finding that even though this claim is a tort claim on its face, it is in substance a claim by a shareholder for a return of what it paid for shares by way of damages.[83]

The Court in *Blue Range* observed that a restructuring plan under the *CCAA* does not provide a statutory scheme for distribution, as it is based on the premise that a plan of arrangement will provide a classification of claims that will be presented to creditors for approval. Creditors conduct business with corporations on the assumption that they will be given priority over shareholders in the event of an insolvency. The Court held that the identification of risk-taking assumed by shareholders and creditors was illustrated by the behavior of Big Bear in that in the course of Big Bear's hostile takeover of Blue Range, it sought access to Blue Range's books and records for information, but had its requests denied. Nevertheless, Big Bear pursued the takeover in the absence of information it knew would have been prudent to obtain. It also actively embraced its shareholder status despite the allegations of misrepresentation, putting Blue Range under the *CCAA* in an attempt to preserve its equity value and, in the result, holding Blue Range's creditors at bay and yet it was also attempting to recover its alleged share exchange loss through the claims approval process and rank with unsecured creditors on its claim.

The Court concluded that fairness dictated that Big Bear's claims should be subordinated; and held that if Big Bear's claim was allowed to rank equally with unsecured creditors, it would open the door in many insolvency proceedings for aggrieved shareholders to claim misrepresentation or fraud.[84] It observed that there may be many situations where there should have been better disclosure of the corporation's declining fortunes, as no one would deliberately invest in a corporation that has become insolvent.[85] The Court in *Blue Range* also observed that despite the differences that may exist between Canadian and U.S. insolvency law in this area, assessment of the fairness of a proposed plan by U.S. courts was persuasive for its reasoning based on equitable principles.[86] The Court acknowledged that caution was to be used in following the approach of U.S. courts to ensure that the principles underlying such approach do not arise from differences between U.S. and Canadian law; however, it found U.S. judges persuasive in their policy reasons for subordinating defrauded shareholder claims to those of ordinary creditors as they are rooted in principles of equity similar to the equitable principles used by Canadian courts.[87] The Court quoted from the U.S. *Newton National Bank* judgment, which held that: "when a corporation becomes bankrupt, the temptation to lay aside the garb of a stockholder, on

82. *Ibid.* at para. 17, citing *Re Central Capital Corp.* (1996), 132 D.L.R. (4th) 223 (Ont. C.A.) at page 245; *Canada Deposit Insurance Corp. vs. Canadian Commercial Bank* (1992), 97 D.L.R. (4th) 385 (S.C.C.) at pages 402 and 408
83. *Ibid.* at para. 29.
84. *Ibid.* at para. 45.
85. *Ibid.* The Court held that although the recognition that this may greatly complicate the process of adjudicating claims under the *CCAA* is not of itself sufficient to subordinate Big Bear's claim, it is a factor that may be taken into account.
86. *Ibid.* at para. 44.
87. *Ibid.* at para. 54.

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one pretense or another, and to assume the role of creditor, is very strong, and all attempts of that kind should be viewed with suspicion".[88]

The Court concluded, based on its characterization of the claim, the equitable principles and considerations set out in the U.S. cases, the general expectations of creditors and shareholders with respect to priority and assumption of risk, and the basic equitable principle that claims of defrauded shareholders should rank after the claims of ordinary creditors in a situation where there are inadequate assets to satisfy all claims that Big Bear must rank after the unsecured creditors of Blue Range in respect to the alleged share exchange loss, the claim for transaction costs and the claim for cash share purchase damages.[89]

In sum, the Court held that it was clear under corporate law and common law principles that shareholders are not entitled to share in the assets of the debtor corporation until ordinary creditors have been paid in full, as creditors assess risk and price their loans on the basis of that priority and shareholders invest with the knowledge that they are taking the risk of business failure.[90] It was also concerned about the administrative difficulties that would be imposed on insolvency professional in trying to process claims. The Court left open the question of whether there were instances in which the fact that a party with a claim in tort or debt is a shareholder is coincidental and incidental, but this appears to be a narrow exception, the Court giving the example of a shareholder who slips and falls outside of the corporate office who may have potential claims in negligence.

The reasoning in *Blue Range* was subsequently endorsed by another judge of the Alberta Court of Queen's Bench in *National Bank of Canada* v. *Merit Energy Ltd.*, where the Court held that the claims of shareholders arising from alleged misrepresentation in a prospectus were subordinate to the claims of the debtor company's unsecured creditors as they were in substance shareholder claims for return of equity investment.[91] The Court held that while the shareholders paid a premium for the shares, the debt features associated with an indemnity from the debtor did not transform that part of the relationship from a shareholder to a creditor relationship. However, the Court also held that the indemnity claims of the underwriters, directors, and officers were not subordinate to the claims of unsecured creditors because they were claims that were provable in bankruptcy, as they were based on contractual, legal, and equitable duties owed by the debtor to the underwriters. Unlike shareholders who assume the risk of insolvency, the underwriters bargained as a creditor, and to subordinate their claims would fundamentally change the underlying business relationship between underwriters and issuers.[92] The Court further held that equitable subordination did not apply, as there was no evidence of inequitable conduct on the part of the underwriters, no corresponding injury to other creditors, or an enhancement of

88. *Ibid.* at 47, citing *Newton National Bank* vs. *Newbegin* 74 F. 135 (8th Cir., 1896) at 140.
89. *Ibid.* at para. 57.
90. *Re Blue Range Resource Corp.* (2000) 15 C.B.R. (4th) 169 (Alta Q.B.), at 17.
91. *National Bank of Canada* vs. *Merit Energy Ltd.* 2001 CarswellAlta 913 (Alta. Q.B.).
92. *Ibid.* at para. 64.

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the underwriters' position.[93] Hence, these claims ranked with other unsecured creditors.[94]

Hence, while there appear to be only two reported cases in Canada, the judgments that have been rendered have used equitable principles and corporate law principles to subordinate shareholder claims in insolvency proceedings without really detailed consideration of securities law violations or the intersection of securities laws and insolvency law and their respective public policy goals. For example, there are a number of differences in Canadian and U.S. securities law that may govern the extent to which investors will have remedies, such as fraud on the market provisions in the U.S. that allow investors to more easily establish claims than a scheme that requires strict causation to be established.[95] Moreover, securities litigation has generally been less frequent in Canada than the U.S. as Canada has a "cost follows result" rule that is generally applied, which acts as a restraint on bringing frivolous or unmeritorious actions. To date there has not been an appellate judgment in Canada on the treatment of claims arising out of securities law violations.

In fairness to the Canadian courts, it is not evident on the face of the first judgments regarding subordination of claims arising from the alleged misconduct of the debtor or its officers that the courts were provided with comprehensive public policy arguments as to why treatment of claims for statutory violations may be deserving of different considerations, as was provided to the High Court of Australia in *Sons of Gwalia*, discussed in Part E below.[96] Moreover, *Blue Range* appears to be highly fact driven, with the court addressing particular conduct of a shareholder in its takeover bid and hence may not offer real guidance to parties. Arguably, the corporate law provisions for plans of reorganization provide a means of dealing with the equity itself; however, they do not provide a means of dealing with damage claims arising from equity rights and this is an area in which the courts need to exercise their gap-filling authority to make determinations as to priority of claims.

While these two judgments suggest fairly rigid subordination of claims for damages arising out of alleged violations of securities law, there are two Canadian judgments that hint at a different approach, but do not determine the question. Although of limited assistance because it was an uncontested endorsement order, Justice Farley of the Ontario Superior Court dealt with the subordination question on an unopposed motion.[97] The Court, in approving a motion for Bell Canada International as a continuing corporation to redeem and pay out on maturity of high yield notes, addressed a pending shareholder action. It held that even if leave was granted to the shareholders by the Supreme Court of Canada and there was subsequent success at trial, the Court did "not see any reasonable justification for any award that might then be granted not being treated as subordinate to the obligations under the

93. The Court left open the question of whether the doctrine applies in Canada, finding that even if it does exist, it was not applicable in the circumstances, *ibid.*
94. *Ibid.* at para. 68.
95. Arguably, however, recent changes to securities law in Canada have moved Canadian securities law closer to the U.S. model.
96. *Sons of Gwalia Ltd vs. Margaretic* (2007) HCA 1.
97. *In the Matter of Bell Canada International Inc.*, Court File No. 02CL-4553 (14 September 2004) (Ont. S.C.J. (Commercial List)), Endorsement of Farley, J.

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High Yield Notes".[98] The Court held that "any exercise in logic or practicality would lead to the reasonable conclusion that such an award relating to secondary market activity (i.e., it not being a section 130 *Securities Act* claim as to a primary issue) should be treated as continuing in priority terms to be the equivalent of equity (and not as debt, whether or not it be subordinated or *pari passu*)".[99] Section 130 refers to liability for misrepresentation in an offering memorandum.[100] Hence, the Court left open the question of whether a claim arising from primary market securities law violations would be treated differently than secondary market purchases.

A second Canadian judgment implies, without deciding the issue, that claims for damages arising out of securities law violations may be creditor claims. *Menegon v. Philip Services Corp.* involved a motion by Philip Services for authorization to enter into a proposed settlement under the Ontario *Class Proceeding Act.*[101] Philip Services Corp. was the parent company of a network of 200 directly and indirectly owned subsidiaries in Canada, the United States and elsewhere.[102] Various class actions alleged that Philip's financial disclosure contained material misstatements in violation of United States securities laws.[103] Menegon commenced a class proceeding in Ontario for misrepresentation and rescission relating to his purchase of Philip shares, alleging violations of Canadian securities law. Philip filed for bankruptcy protection in the United States and for protection in Canada under the *CCAA*.

The shareholder class actions in both the U.S. and Canada were based on the same non-disclosure. In the U.S., the class action claims were clearly subordinated and had no voting rights because of s. 510(b) of the *Bankruptcy Code*, but in Canada, there was no equivalent provision. In addition, the auditors and underwriters had claims for indemnification against the company as they were co-defendants in the class actions and claimed that they also had been misled. The auditors had prepared consolidated audited financial statements of the Canadian parent and its many U.S. and Canadian subsidiaries. Under the U.S. *Bankruptcy Code*, these claims would be subordinated and would have no voting rights. In Canada, there was no equivalent rule. The problem was that there were identical claims against one company that were entitled to different treatment on different sides of the border.

Given the nature and quantum of the claims, a resolution of the class action proceedings was an essential element of any successful restructuring and the parties entered into a memorandum of understanding that outlined a proposed settlement

98. Ibid. at para. 3.

99. Ibid.

100. Section 130 of the Ontario *Securities Act*, R.S.O. 1990, c. S. 5, as amended specifies: "130.1 (1) Where an offering memorandum contains a misrepresentation, a purchaser who purchases a security offered by the offering memorandum during the period of distribution has, without regard to whether the purchaser relied on the misrepresentation, the following rights: (1) The purchaser has a right of action for damages against the issuer and a selling security holder on whose behalf the distribution is made. (2) If the purchaser purchased the security from a person or company referred to in paragraph 1, the purchaser may elect to exercise a right of rescission against the person or company. If the purchaser exercises this right, the purchaser ceases to have a right of action for damages against the person or company".

101. Menegon vs. Philip Services Corp. (1999) O.J. No. 4080 (Ont. S.C.J. (Commercial List)).

102. Ibid. at para. 2.

103. The class action proceedings were an action for misrepresentation, negligent misrepresentation and rescission relating to the purchase of shares. The actions were consolidated and ultimately dismissed, though an appeal was pending at the time of this judgment.

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between Philip and the U.S. and Canadian class action proceedings.[104] Under the plan each class of stakeholders in the group of companies with similar characteristics were to be treated similarly whether they are located in the U.S. or Canada.[105] Hence, the plan proposed that the claims of Philip's creditors, whether Canadian or U.S., were to be dealt with under the U.S. Plan and governed by Chapter 11 of the U.S. *Bankruptcy Code*, including the claims of the auditor, the underwriters, and officers and directors for contribution and indemnity in relation to the U.S. and Canadian class proceedings. The Court held that class proceedings were certified as against Philip for settlement purposes only.

The Court held that it was premature to approve a settlement of the U.S. and Canadian class action proceedings at that stage of the restructuring process.[106] The Court held that the class action plaintiffs and the co-defendants are all unsecured claimants of Philip:

> The class action plaintiffs and the co-defendants are all unsecured claimants of Philip in the restructuring process—the claim of the co-defendants for contribution and indemnity against Philip and its former officers and directors arise out of the same "nucleus of operative facts" as the claims of the class action plaintiffs against Philip; and one follows from the other. It has frequently been noted that the full name of the *CCAA* is "An Act to facilitate compromises and arrangements between companies and their creditors". In the bare-knuckled ring of commercial restructuring negotiations, this cannot be accomplished if one group of unsecured claimants is given an unwarranted advantage over another.[107]

The Court was not persuaded by submissions that if the proposed settlement was not approved, the U.S. and Canadian class action plaintiffs would get nothing because Philip would be liquidated.[108] The Court held that where the proposed structure of the reorganization affects the substantive rights of claimants in a fashion that treats them differently than they would otherwise be treated under Canadian law, and where the effect of that treatment is to place the claimants in a position where their ability to engage in full and complete negotiations with the debtor company are impaired, there is cause for concern on the part of the court; hence the loss of the right to vote in the Canadian plan was problematic.[109]

The Court held that while the fact that treatment of claims under U.S. bankruptcy law would be considerably less favorable than their treatment under Canadian law was not determinative, it was a factor for consideration when taken in conjunction with the loss of voting rights in the Canadian plan.[110] It held that for purposes of the *CCAA*, the claim of an unsecured creditor includes a claim in respect of any indebtedness, obligation of liability that would be a claim provable in bankruptcy, and therefore included a contingent claim for unliquidated damages.[111] Thus, the claimants were all entitled to assert claims in the *CCAA* proceedings. The Court held that the extension of comity as between courts in cross-border insolvency situations

104. *Menegon vs. Philip Services Corp., supra*, note 101 at para. 13.
105. *Ibid.* at para. 17.
106. *Ibid.* at para. 29.
107. *Ibid.* at para. 29.
108. *Ibid.* at para. 32.
109. *Ibid.* at paragraphs 35–36.
110. *Ibid.* at para. 39.
111. *Ibid.* at para. 40.

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are matters of great importance in order to facilitate the orderly implementation of insolvency arrangements. However, it held that comity and international cooperation do not mean that one court must cede its authority and jurisdiction over its own process or over the application of the substantive laws of its own jurisdiction.[112] The Court concluded that the Canadian plan was flawed because it sought to exclude Canadian claimants from participation in its process by providing that their claims against Philip were to be governed by the U.S. proceedings while at the same time seeking to bind them to the provisions of the Canadian plan, all without affording those claimants any right to vote.[113]

The Philips judgment indicates that the court viewed the claims for damages arising out of securities law violations as unsecured claims and it expressed concern about a proposed settlement that compromised the right of those claimants to vote on a Canadian *CCAA* plan, although the court did not have to make a definitive determination on the ranking of the claims.[114] The case also illustrates that it would be helpful to have coordination of Canadian and U.S. law on the issue of treatment of equity claims as a means of facilitating the reorganization of corporate groups. Almost all Canadian public companies have a cross-border aspect to their business, and when a large company and its subsidiaries are in concurrent *CCAA* and Chapter 11 proceedings, often the restructuring plan involves restructuring the company and its subsidiaries as a whole. However, if the same type of claim has a different priority and rights in one country than the other, this can be very difficult, and hence requires further public policy consideration.

Subsequent to all of these Canadian judgments, Ontario and Alberta, the provinces in which the above cases were decided, have enacted civil liability regimes for secondary market disclosure. To date, there have been no cases that deal with the intersection of these securities law remedies and remedies under insolvency legislation. It does raise the public policy question of whether there should be a difference in treatment of claims arising from the primary or secondary market. In the former case, the company treasury benefits or the officers personally benefit through resultant bonus compensation, so there may be validity in considering a claim for damages arising out of a prospectus misrepresentation as a creditor claim. The purchaser of the equity would not become a shareholder in respect of that investment but for the company misrepresenting its financial status or prospects in the prospectus. The claimant may or may not be an existing investor in the firm. With respect to secondary market purchases, there is no direct cash to the company treasury from the misrepresentation or other misconduct, and other market players may benefit to the extent of the detriment. While the company benefits indirectly from the misconduct

112. Ibid. at para. 48. Section 18.6(5) of the *CCAA* provides that nothing requires the Court to make any order that is not in compliance with the laws of Canada or to enforce any order made by a foreign court.

113. Ibid. at paragraphs 49, 55. The question of approval of the Settlement, in its present form or some other form was adjourned to a date to be fixed which is more contemporaneous with the sanctioning hearing. Ultimately, the case was resolved by having a reorganization plan under Chapter 11 and a receivership in Canada.

114. In *Laidlaw*, the same problem arose. The jurisdictional issue was solved by having the Canadian proceedings dealt with as ancillary proceedings to the Chapter 11 filing.

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violating securities law in the form of a better credit rating that arises from the market price, this may not be a sufficient reason to treat such claims as debt claims in that company's insolvency proceeding. These differences merit further study.

In Canada, there is now proposed statutory language that will codify subordination of equity claims, as discussed in the following part.

D. Proposed statutory language in Canada to subordinate equity claims

While common law and corporate law principles continue to govern the treatment of equity claims in insolvency, in Canada there is proposed statutory language that will codify subordination of equity claims pursuant to two sets of proposed statutory amendments to the *BIA* and the *CCAA* in 2005 and 2007.[115]

In Canada, the Senate Committee on Banking trade and Commerce in 2003 identified the uncertainty as to the treatment of shareholders' claims in insolvency, given the lack of express statutory language; its view was that "Canadian insolvency law does not subordinate shareholder or equity damage claims", although the basis of that view is unclear in the report.[116] The Senate Committee observed that:

> In view of recent corporate scandals in North America, the Committee believes that the issue of equity claims must be addressed in insolvency legislation. In our view, the law must recognize the facts in insolvency proceedings: since holders of equity have necessarily accepted—through their acceptance of equity rather than debt—that their claims will have a lower priority than claims for debt, they must step aside in a bankruptcy proceeding. Consequently, their claims should be afforded lower ranking than secured and unsecured creditors, and the law—in the interests of fairness and predictability—should reflect both this lower priority for holders of equity and the notion that they will not participate in a restructuring or recover anything until all other creditors have been paid in full. From this perspective, the Committee recommends that: the *Bankruptcy and Insolvency Act* be amended to provide that the claim of a seller or purchaser of equity securities, seeking damages or rescission in connection with the transaction, be subordinated to the claims of ordinary creditors. Moreover, these claims should not

115. *An Act to Establish the Wage Earner Protection Program Act, to amend the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act and to make consequential amendments to other Acts*, S.C. 2005, Chapter 47, Royal Assent 25 November 2005, not yet proclaimed in force as of 14 June 2007 (Chapter 47). At the time of enactment, all parties agreed that the statute would not be proclaimed in force until the Senate had the opportunity to hold further hearings and make amendments. Further amendments were introduced under Bill C-52 *An Act to implement certain provisions of the budget tabled in Parliament on 19 March 2007*, Royal Assent 22 June 2007, Chapter 29 Statutes of Canada (amending the provisions for eligible financial contracts); and Bill C-62, *An Act to amend the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act, the Wage Earner Protection Program Act and chapter 47 of the Statutes of Canada, 2005*, third reading 14 June 2007, pending before the Canadian Senate as of 14 June 2007 as this paper goes to press.

116. Standing Senate Committee on Banking Trade and Commerce, *Debtors and Creditors Sharing the Burden*, 2003 at 159.

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participate in the proceeds of a restructuring or bankruptcy until other creditors of the debtor have been paid in full.[117]

Several years later, such amendments are still pending.[118] Aside from the Senate Committee report, however, there has been remarkably little public policy debate in respect of whether there is a need to codify the status of securities claims under Canada's insolvency legislation, notwithstanding that amendments pending will subordinate all equity claims. The Joint Task Force on Business Law Insolvency Reform, a task force of two professional organizations, The Insolvency Institute of Canada and the Canadian Association of Insolvency and Restructuring Professionals, made strong policy submissions in support of subordination language.[119] Other than this submission, there is little evidence of public policy debate, particularly in respect of claims arising from securities law violations.

One factor that may be driving the proposed amendments is pressure to align the Canadian provisions with those in the U.S. The above discussion of the Philip case highlights the issue. Some insolvency cases in which debtor corporations were registered in Canada had their claims processed in U.S. proceedings, arguably because creditors wanted the higher degree of certainty that the U.S. strict subordination regime offered.[120] There had been some concern expressed by creditors about the different statutory treatment in the two jurisdictions, one codified and the other not, although as noted above, the only reported cases in Canada gave the identical treatment to equity claims as under the highly codified U.S. *Bankruptcy Code.* Once the Canadian amendments are enacted, such cross-border cases will have to comply with center of main interest tests under Chapter 15 of the U.S. *Bankruptcy Code* and the proposed new cross-border provisions of the Canadian *BIA* and *CCAA*, making venue choice more transparent and predictable and arguably less amenable to forum shopping. However, if there is a major substantive difference between Canadian and U.S. treatment of claims for damages, there will be a continuing incentive for debtors to forum shop and argue that the center of main interests of a Canadian parent company or a Canadian subsidiary is in the U.S. when it has cross-border issues of this type.

If the proposed amendments are enacted, the *BIA* will specify that a party is not entitled to a dividend in respect of an equity claim until all claims that are not equity claims have been satisfied.[121] The statute will define equity interest and equity claims for the first time.[122]

117. *Ibid.* at 159.

118. Although the Chapter 47 amendments were enacted, they were not proclaimed in force on the basis that all parties agreed the statute would go to the Senate for public hearings and possible amendment. There was a hiatus of a year and a half because of the minority federal government and the need for all parties agreement on the legislative agenda. Instead, the Government introduced a further amending Bill C-62, *supra*, note 115, and that Bill received third reading in the House of Commons in early June 2007 and is likely to be scheduled for Senate hearings in the fall of 2007.

119. Joint Task Force on Business Insolvency Law Reform, *Final Report*, 2002 at 32.

120. The *Laidlaw* and *Loewen* proceedings are arguably examples of this, although each had extensive operations in the U.S. and hence numerous claims were located there.

121. Bill C-62, *supra*, note 115, proposed s. 140.1, *BIA*.

122. Bill C-62, *ibid.*, proposed s. 2, *BIA*.

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

"equity claim" means a claim that is in respect of an equity interest, including a claim for, among others, (a) a dividend or similar payment, (b) a return of capital, (c) a redemption or retraction obligation, (d) a monetary loss resulting from the ownership, purchase or sale of an equity interest or from the rescission, or, in Québec, the annulment, of a purchase or sale of an equity interest, or (e) contribution or indemnity in respect of a claim referred to in any of paragraphs (a) to (d).[123]

Hence, the proposed definition clearly includes claims for losses arising out of purchase or sale of equity investments, which will be considered equity claims and not a debt or liability for purposes of insolvency proceedings; and the proposed statutory language makes no distinction for claims arising out of securities law violations.

In addition, provisions of the *BIA* that currently specify that debts not discharged in bankruptcy for public policy reasons include fraudulent misrepresentation, will now be amended to specify that "any debt or liability resulting from obtaining property or services by false pretences or fraudulent misrepresentation, other than a debt or liability that arises from an equity claim" is not discharged.[124] The policy rationale for the proposed change is that investors willingly engage in taking risk of loss or profit in making equity investments, and that although investors have a right of action against the company where they are fraudulently misled into investing in a business, when a firm is financially distressed, shareholders should be placed at the bottom of the priority of claims.[125]

Under the proposed Canadian statutory reform, no proposal under the *BIA* or plan of compromise or arrangement under the *CCAA* that provides for the payment of an equity claim is to be approved by the court unless the proposal or plan provides that all claims that are not equity claims are to be paid in full before the equity claim is to be paid.[126] This language may be too rigid in that in some cases there may be claims for damages from securities law violations and other creditors may decide that it is helpful to place some value on the table in order to reach agreement on a restructuring plan or because there is goodwill or other reputational reasons to recognize and value such claims. The language as currently proposed would prevent giving such claimants any remedy where other creditors are not paid in full and thus may prevent a positive outcome in some circumstances.

A statutory amendment that specifies "unless the court determines that it is 'fair and equitable' or 'fair and reasonable' to order otherwise", would grant the court authority

123. Bill C-62, *ibid.*, proposed s. 2, *BIA* and proposed s. 2, *CCAA*.

124. Bill C-62, *ibid.*, proposed s. 178(1)(e) *BIA*.

125. Government Briefing Book, Chapter 47 amendments at bill clause no. 37.

126. Bill C-62, *supra*, note 115, proposed s. 60(1.7), *BIA* and proposed s. 6(8), *CCAA*.

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to exercise its discretion in particular circumstances based on the equities in the case. It would allow the court to approve a remedy in cases where damages are sought for egregious conduct on the part of the debtor corporation and its officers. The other option would be to remove damage claims arising out of securities law violations from the above proposed definition of equity claim because, arguably, such claims are not equity claims. The proposed Canadian legislation as currently framed fails to recognize that claims for damages arising out of deception or statutory violations are more similar to claims by creditors for breach of contracts or commercial arrangements than they are to ordinary claims by shareholders to the residual equity in the firm.

In restructuring proceedings, the proposed statutory language specifies that creditors having equity claims are to be in the same class of creditors in relation to those claims, unless the court orders otherwise, but may not vote at any meeting, unless the court orders otherwise.[127] This authority codifies current practice where courts have allowed equity claimants to vote where there is still equity remaining in the debtor corporation. The public policy objective of the proposed amendments is to reduce the power of equity claimants, who might otherwise control the voting where they have substantial claims, and thus avoid any ability to defeat a restructuring plan that has the requisite support of creditors.[128] The language proposed in the 2007 amendments tempered an earlier proposed complete prohibition on voting to add the phrase "unless the court orders otherwise". However, this authority will be of limited assistance to claimants arising out of securities law violations unless the subordination provision in a restructuring is also amended as discussed in the previous paragraph.

The proposed amendments also specify that a plan of compromise or arrangement may not deal with a claim that relates to any debt or liability resulting from obtaining property or services by false pretenses or fraudulent misrepresentation unless the creditor in relation to that debt has voted for the compromise, other than a debt or liability that arises from an equity claim.[129] Thus, a debtor corporation will need the consent of creditors to compromise such claims but will not require the consent of equity claimants for the same liability.

The amendments also specify that the stay order in a restructuring proceeding will not affect the rights of a regulatory body with respect to any investigation in respect of the company or any action, suit or proceeding to be taken by it against the company, except when it is seeking to enforce any of its rights as a secured creditor or an unsecured creditor.[130] There is an exception where the court determines that a viable compromise or arrangement could not be made in respect of the company if that subsection were to apply and where it is not contrary to the public interest that the regulatory body be affected by the stay order.[131]

The proposed changes were passed by the House of Commons and sent to the Canadian Senate in June 2007 and may come into force later this year, depending

127. Bill C-62, *ibid.*, proposed s. 54.1, *BIA* and s. 22.1, *CCAA*.
128. Government Briefing Book, Chapter 47 amendments at bill clause no. 37.
129. Bill C-62, *supra*, note 115, proposed s. 19(2), *CCAA*.
130. Bill C-62, *ibid.*, proposed s. 69.6, *BIA* and proposed s. 11.1 (1), *CCAA*.
131. Bill C-62, *ibid.*, proposed s. 11.1, *CCAA* and s. 69.6, *BIA*.

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upon whether or not Canada faces a federal election. During the legislative process, there was very little policy debate as to whether adopting the U.S. approach to equity claims was preferable to one that has distinguished between ordinary equity claims and those claims arising out of corporate officers' violations of corporate or securities statutes. In part this may be a function of the highly integrated nature of Canadian and U.S. capital markets and the pressure to align both securities and insolvency systems to a certain extent. However, there has not been public debate in respect of whether there are different policy implications given that debtors can enter Chapter 11 proceedings in the U.S. where they are not insolvent, whereas in Canada, insolvency is a pre-requisite to access to proceedings.

Arguably, the lack of policy debate is also a function of there not being an active plaintiff's bar in Canada yet, given the very recent nature of civil remedies, which might have at least raised the public policy issue of whether claims arising out of egregious corporate conduct ought to be treated differently than ordinary business risk. There may also be a cultural difference, in that Canadians generally do not believe that they are as vulnerable to massive corporate fraud as the U.S. is, although cases such as Bre-X are evidence that securities law fraud can occur in Canada. A positive aspect of the proposed statutory language is that it focuses on the nature of the claim and not the claimant, in keeping with jurisprudential treatment of claims generally and the rationale for distinguishing equity claims from debt claims.

Hence the proposed statutory language more closely resembles that in the U.S. than in the U.K. or Australia, which are discussed below. The policy rationale is that investors willingly engage in taking risk of loss or profit in making equity investments, and that although investors have a right of action against the company where they are fraudulently misled into investing in a business, when a firm is financially distressed, equity claimants should be placed at the bottom of the priority of claims.[132]

At the same time as Canada is considering insolvency law reform, new statutory civil remedies for securities law violations have been introduced. Two jurisdictions with more than 85% of the capital market activity in Canada, Ontario and Alberta, recently granted securities holders the right to bring civil suits for misrepresentation; Saskatchewan has followed suit effective 2008, with British Columbia likely to follow.[133] The provisions are aimed at giving meaningful remedies to investors where corporate officers act in violation of continuous disclosure requirements. Since Canadian securities law is premised on disclosure and transparency, the new provisions are an important new tool to ensure the integrity of the system. These provisions are aimed at overcoming common law barriers to remedies by adding a deemed reliance provision such that causation need not be proven. While it is too early to tell what the effect of such provisions will be, where the impugned companies are

132. Chapter 47 Government Briefing Book, Chapter 47 amendments at bill clause no. 37.

133. See for example, the Ontario *Securities Act*, *supra*, note 100, at Part XXIII.1, which provides for civil liability for secondary market disclosure, and creates a right of action for damages where an issuer fails to make a timely disclosure of a material change or where there is an uncorrected misrepresentation relating to the affairs of the issuer.

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insolvent, the new remedies will be largely ineffective, given the current proposed amendments to the *BIA* and *CCAA*.

There is a further issue of the timeliness of the insolvency process, which in Canada is conducted on a "real-time basis" and the implications for resolving securities law claims or allowing contingent claimants to control the process. Equally, however, the subordination of equity claims, as currently defined in the proposed legislation, may encourage debtor corporations to enter restructuring proceedings in order to subordinate claims, on the basis that if the claims were realized, the company would be insolvent within the meaning of Canadian insolvency legislation. Recent caselaw in Canada has held that "insolvent" should be given an expanded meaning under the *CCAA* in order to give effect to the rehabilitative goal of the statute; and that a court should determine whether there is a reasonably foreseeable expectation at the time of filing that there is a looming liquidity condition or crisis that will result in the applicant running out of money to pay its debts as they generally become due in the future without the benefit of the stay and ancillary protection.[134] This broader definition has facilitated going concern restructurings but may also create inappropriate incentives when coupled with the proposed provisions that subordinate all equity claims in a *CCAA* restructuring proceeding. If the securities claims or other equity-related claims against a debtor are so large they render the debtor insolvent, there is nothing inappropriate about entering restructuring proceedings to deal with the claims and to devise a going forward business strategy. However, if the subordination of claims might encourage tactics where a filing is done as a means to wipe out equity claims without a vote and without compensation, the proposed legislative amendments may or may not provide a means to deal with the issue. If there is a reasonable argument that there is net value in the business after other claims but before the equity claim, the court could decide to exercise its power to allow the holders of the equity claim to vote, providing claimants with leverage in the Canadian system, where there is no cram-down.

In sum, Canada's proposed statutory regime for the subordination of equity claims will make it one of the strictest in the world, not tempered by other legislation that will allow investors to realize at least some of their claims arising from harms due to the misconduct of corporate officers. Such changes have not received full public policy discussion in Canada, and appear aimed at aligning Canada's insolvency regime with the U.S. However, Canada does not have the mechanisms and resources afforded to U.S. securities regulators to provide remedies to harmed equity investors and that allow regulators to serve a gatekeeping function such that insolvency proceedings can continue to provide an expeditious resolution to the firm's financial distress. Some provinces have enacted provisions allowing for a forfeiture of funds and some restitution to investors, but given that Canada is a federal regime, provincial securities law remedies come up against federal paramountcy concerns even if

134. *Re Stelco Inc.* (2004), 2004 CarswellOnt 1211, 48 C.B.R. (4th) 299 (Ont. S.C.J. [Commercial List]), leave to appeal to C.A. refused (2004), 2004 CarswellOnt 2936 (C.A.).

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they were strengthened to include fair funds type of provisions with enforcement teeth behind them.[135]

In contrast to the Canadian approach, the courts in the U.K. and Australian have tried to reconcile the claims made under securities law and insolvency law schemes.

E. Distinguishing the type of shareholder claims and consequences for subordination—U.K. and Australia

In the U.K., member (shareholder) claims are generally subordinated in insolvency proceedings, based on the same principles as articulated above. In the case of misconduct under securities laws, the House of Lords has adopted a more purposive approach to reconciling securities claims and insolvency priorities.

Section 74(2)(f) of the U.K. *Insolvency Act 1986* specifies that a "sum due to any member of the company, in his [her] character of a member, by way of dividends, profits or otherwise is not deemed to be a debt of the company, payable to that member in a case of competition between himself [herself] and any other creditor not a member of the company, but any such sum may be taken into account for the purpose of the final adjustment of the rights of the contributories among themselves".[136] The U.K. *Act* also specifies that a person is not disbarred from obtaining damages or other compensation from a company by reason only of holding shares in the company and any right to subscribe for shares or to be included in the company's register in respect of shares.[137] The specific language has given rise to the question of whether a claim by a member arising out of misconduct by the debtor corporation or its officers should be treated as a claim "in his character of a member" and, therefore, subordinated, or should be treated as a claim in his or her character as a tort victim, not as "a member", and therefore not subordinated.

In *Soden v. British & Commonwealth Holdings Plc.*, a successful takeover bidder, British & Commonwealth Holdings ("B&C") had purchased the whole of the share capital of the target company for £434 million and sought damages for negligent misrepresentation against the target company when the latter's financial distress became known after the completion of the takeover.[138] The target company went into administration and the court approved a scheme of arrangement to which the bidder, B&C was not a party. The action for damages had not come to trial and the Administrator sought direction on whether B&C's action and another action for third party contribution, if successful, would be subordinated to the claims of other creditors. The critical question for the House of Lords was whether damages ordered for negligent misrepresentation would constitute "a sum due to a member in its character of a member".[139] The House of Lords held that s. 74(2)(f) requires a distinction to be

135. See for example, the B.C. *Civil Forfeiture Act*, which came into force on April 20, 2006. Pursuant to the Act, the Province can apply to the Supreme Court of British Columbia to seize and sell assets acquired through unlawful activity. The *Act* also allows disposal of forfeited proceeds to eligible victims.

136. Section 74(2)(f), U.K. *Insolvency Act 1986*. While member refers to equity investors under U.K. legislation, this paper will refer to members and shareholders interchangeably for the remainder of the paper.

137. Section 111A, U.K. *Insolvency Act 1986*.

138. *Soden vs. British & Commonwealth Holdings plc* (1998) AC 298 (H.L.). It is unclear from the judgment why the acquiring B&C was not alerted to the corporation's true financial condition.

139. *Ibid.*

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drawn between sums due to a member in his or her character as a member and sums due to a member otherwise than in his or her character as a member, and that sums due in the character of a member must be sums falling due under and by virtue of the statutory contract between the members and the company pursuant to provisions of the U.K. *Corporations Act*, that is, arise out of a cause of action on the statutory contract.[140] The House of Lords held that the relevant principle is not that "members come last", but rather that the "rights of members as members come last", that is, rights founded on the statutory contract are, as the price of limited liability, subordinated to the rights of creditors. The rationale of the section is to ensure that the rights of members as such do not compete with the rights of the general body of creditors; however, a member having a cause of action independent of the statutory contract is claiming as a creditor and is in no worse position than any other creditor.[141]

The House of Lords further held that the subordination provision, s. 74(2)(f), of the U.K. *Insolvency Act*, did not apply to the takeover bidder because it had purchased shares in the market and not directly from an offering of the debtor company.[142] The House of Lords held that the misrepresentation claims of transferee shareholders should not be subordinated and should rank *pari passu* with unsecured creditors. Hence, the subordination provisions have been interpreted to apply to subscribing shareholders and not transferees.

Essentially, the U.K. court has distinguished the nature of the claim based on the statutory contract of shareholding. It is not a distinction based on fraud versus ordinary business risk associated with equity investments. However, since remedies that arise out of secondary market purchases are remedies for fraud and misrepresentation, the courts are effectively distinguishing on that basis, although only for secondary market purchasers. The reasoning of the House of Lords is the opposite of the reasoning in the Canadian case discussed above.

In Australia, the statutory language is similar to the U.K. Previously, it was generally thought that the subordination provision contained the Australian *Corporations Act, 2001*, which specifies that: "payment of a debt owed by a company to a person in the person's capacity as a member of company, whether by way of dividends, profits or otherwise, is to be postponed until all debts owed to, or claims made by, persons otherwise than as members of the company have been satisfied" meant that shareholders' claims against the debtor company are to be subordinated to the claims of creditors, the Australian courts drawing on early English caselaw.[143] More recently, the Australian courts had adopted a different approach, similar to the reasoning of

140. *Ibid.* Section 14(1) of the Act specifies that the memorandum and papers bind the company and its members.

141. *Ibid.*

142. *Ibid.*

143. In *Webb Distributors (Aust) Pty Ltd. vs. The State of Victoria* (1993) 179 CLR 15; (1993) HCA 61, the Australian High Court held that the *Corporations Act* subordination provisions extended to subordinate the claims of shareholders for misleading and deceptive conduct under the Australian *Trade Practices Act, 1974*. The Court relied on the U.K. House of Lords judgment in *Houldsworth vs. City of Glasgow Bank* (1880) 5 App Cas 317, which held that members cannot claim damages for misrepresentation inducing the purchase of shares while the member continues to be on the share registry; and that members cannot rescind their membership when a company is insolvent. See also *Re Addlestone Linoleum Co.* (1887) 37 Ch D 191. The U.K. corporations statute was amended in 1985 to specify that shareholders were not prohibited from claiming damages only by reason of the fact they continued to be shareholders.

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the U.K. House of Lords, in *Soden v. British & Commonwealth Holdings Plc, supra* for treatment of claims arising from statutory violations.[144] However, the High Court of Australia took a different analytical approach in *Sons of Gwalia Ltd. v. Margaretic*, decided in January 2007.[145]

Sons of Gwalia Ltd. v. Margaretic marks a departure from the U.K. reasoning and reflects further development of the Australian court's balancing of different public policy objectives. An investor that purchased shares in Sons of Gwalia Ltd. in the secondary market shortly before the company entered insolvency administration claimed damages pursuant to trade practice and securities legislation on the basis that the company had engaged in misleading and deceptive disclosure in that it failed to disclose material adverse information.[146] Specifically, Margaretic alleged that the company had failed to notify the Australian Stock Exchange that its gold reserves were insufficient to meet its gold delivery contracts and that it could not continue as a going concern, and had misled or deceived Margaretic into buying shares. The shareholder sought to be treated as an unsecured unsubordinated creditor. The court at first instance, the Full Court of the Federal Court and the High Court of Australia all found that the shareholder could be treated as an unsecured creditor because the claim was not "in the person's capacity as a member of the company", although the reasoning of the High Court differs from the lower courts. Given that the shares were purchased in the secondary market, the Federal Court held that his claim under the misleading and deceptive statutory provisions did not arise in his capacity as member, adopting the approach of the U.K. House of Lords.[147]

The High Court of Australia upheld the results, but declined to accept the U.K. reasoning. By a majority of 6-1, the High Court held that a shareholder with a claim under a statute against a company for misleading or deceptive conduct, or for failure to comply with its continuous disclosure obligations could prove in the administration or liquidation of that company in respect of the damages for which the company was liable, and that this applied whether the shareholder acquired the shares by subscription or purchase.[148] This ability to claim applied even though the investor's loss did not crystallize before the administration. The Court held that it would not have applied to equity investors that had sold their shares before the company went into insolvency administration, or who were never on the register, because they invested through nominees, custodians or trusts, as those investors would not have been postponed on any view.[149] The majority of the High Court held that s. 563A of

144. *Cadence Asset Management vs. Concept Sports Ltd.* (2005) 147 FCR 434.

145. *Sons of Gwalia Ltd vs. Margaretic* (2007) HCA 1.

146. *Ibid.* at para. 8. Specifically, he claimed breach of disclosure requirements under securities law continuous disclosure obligations; and misleading or deceptive conduct pursuant to s. 1041H of the *Corporations Act, 2001* (Australia) and s. 12DA of the *Securities and Investments Commission Act, 2001* (Australia); and s. 52 of the *Trade Practices Act*, (Australia).

147. See also *Re Media World Communications* (2005) FCA 51, 52 ACSR 346 (Australia), where the Federal Court of Australia Victoria District adopted the reasoning in *Sons of Gwalia*, but on the facts of that case, it was not a situation where shares were acquired by the shareholder from a third party and the Court held that if the company is in liquidation, the subscribing shareholders' right to be paid a loss from a prospectus purchase (i.e., in their capacity as investors) is postponed under s. 563A, *Corporations Act, 2001* until the claims of persons other than members have been satisfied.

148. Hence, while the Full Federal Court had adopted the reasoning in *Soden* in distinguishing transferees from subscribers, the majority of the High Court did not adopt this analysis.

149. *Sons of Gwalia Ltd vs. Margaretic, supra*, note 146.

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the *Corporations Act, 2001* did not operate to postpone the debts owed to shareholders with claims against a company for misleading or deceptive conduct. Shareholders with such claims were not owed debts in their capacity as members of the company. Rather, they were seeking to enforce against the company remedies to which they were entitled under various statutes providing protection to investors.

The Chief Justice of the High Court held that the determining factor was that the shareholder's claim was not founded upon any rights he obtained or any obligations he incurred by virtue of his membership of the company.[150] He noted that modern legislation has greatly increased the scope for shareholder claims with more intensive regulation of corporations, breach of which may sound in damages for the protection of members of the investing public.[151] He wrote:

> On the one hand, extending the range of claims by shareholders is likely to be at the expense of ordinary creditors. The specter of insolvency stands behind corporate regulation. Legislation that confers rights of damages upon shareholders necessarily increases the number of potential creditors in a winding-up. Such an increase normally will be at the expense of those who previously would have shared in the available assets. On the other hand, since the need for protection of investors often arises only in the event of insolvency, such protection may be illusory if the claims of those who are given the apparent benefit of the protection are subordinated to the claims of ordinary creditors.[152]

The Court proceeded to distinguish the language under Australian legislation from the subordination language in the U.S. *Bankruptcy Code.* The High Court judgment is significant in that it distinguishes claims arising from deceptive practices from those that arise normally in a shareholder's capacity as shareholder. In this respect, the High Court noted that claims arising under securities, corporate, and trade practices legislation are not restricted to only shareholders and hence do not arise out of the shareholder contract. The judgment is aimed at a balance between securities, corporate, and insolvency law regimes, allowing shareholder claims arising out of securities laws violations essentially to rank with ordinary creditors based on the terms of the applicable Australian statute, which did not contain the U.S. statute's express subordination mandate.[153]

The recent cases in the U.K. and Australia raise some interesting issues in respect of securities claims in insolvency.[154] First, those with claims against the debtor corporation for its misconduct are found to resemble unsecured creditors more closely than equity claims. Arguably, the recognition of these types of claims as creditor claims by the U.K. and Australian courts is based in part on the express statutory language, and in part on the recognition by the courts that it is important to give public policy recognition to the objectives of both securities law and insolvency law in

150. *Ibid.* All of the Justices wrote a decision.
151. Gleeson, C.J., *ibid.* at para. 17.
152. *Ibid.* at para. 17.
153. The judgment deals with the status of the claim if it is established; it does not determine the case on its merits.
154. Craig Edwards has suggested that courts in New Zealand are likely to follow the reasoning of the Australian court, although to recover damages from New Zealand's Fair Trading Act, the complainant must show reliance on the misleading conduct and causation, which may be difficult to establish. Craig Edwards, "Headaches for Insolvency Practitioners as a Result of the *Sons of Gwalia* Decision, NZ Insolvency Bulletin, March 2007 at 2.

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order to support fair and efficient capital markets. Another issue is whether recognition of such claims will create particular incentive effects, such as creating incentives to make such claims as a means of being recognized as a creditor in the negotiations for a workout or other outcome of a firm's insolvency.

In the *Sons of Gwalia* case, there are 5304 shareholder claims made in the administration, asserting aggregate damages of Aus $242 million arising from allegations of violations of securities, corporate, and trade practices legislation.[155] The case illustrates that if such claims are to be treated on parity basis with unsecured creditors, there may be huge implications for the pool of assets available to satisfy creditors' claims. Moreover, it raises the question of the timeliness and efficiency of how such claims are to be determined. However, the Australia High Court's reasoning may not create extensive remedies for shareholders and substantial losses for creditors in the amount of assets available to satisfy their claims in many insolvency proceedings. There are hurdles to shareholders proving that the company engaged in prohibited conduct and that the conduct led to his or her loss or damage. The *Sons of Gwalia* case only establishes that a shareholder can bring an action.

There are also hurdles to pursuing shareholder litigation under the English rule of legal costs. In Australia, however, the courts have approved the ability of litigation funding firms to provide funding not only for the prosecution of shareholder claims but also to indemnify the shareholders against an adverse costs order. In a somewhat imperfect fashion, this funding mechanism helps to minimize the pursuit of spurious shareholder claims, on the basis that for-profit litigation funding firms are not likely to pursue shareholder claims unless the funders have concluded that there is a high probability of success on the merits. In the U.K., on the other hand, litigation funding firms have not found favor, which is likely the principal reason why shareholder damages claims are rarely asserted in U.K. insolvencies as a practical matter.

From an administrative perspective, the ability of shareholders to bring claims under insolvency proceedings raises the question of whether there will be higher administration costs as administrators assess whether to admit shareholder claims, and in dealing with challenges to their decisions. Absent a statutory framework that creates a "deemed reliance" on the conduct such that causation need not be proven, the processing of these claims could prove extremely costly and time consuming, both for insolvency administrators and for the claimants, whether they are proceeding by class action or individually. Another issue is how insolvency professionals are going to assess the quantum of the loss and damage, particularly where there are many investors seeking a remedy for the misconduct of the debtor company. Given that these claims are contingent in the sense that while the claim has crystallized at insolvency, the scope of liability and damages has not yet been determined; and given that there are time pressures in insolvency proceedings, a concern is that such claims may detract from developing a viable going forward business plan, particularly where shareholders do not see any upside in compromising their claims in order to facilitate

155. Ferrier Hodgson, *Report to Creditors, Sons of Gwalia*, ACN 008994287 (24 November 2006); http://www.ferrierhodgson.com.au/caseprofiles/details.cfm?objectID=11.

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a restructuring. Moreover, this additional process may affect the timeliness of meeting creditors' claims. Equally, however, the Australian court has sought to strike a balance between two important public policy goals.

Subsequent to the judgment, shareholders of Gwalia were permitted to vote on a proposed sale of the business by the administrators, even though the alleged fraud had not been proven and reliance not yet established, and they were permitted to vote the full amount (Aus $250 million) of their claims, some of which were quite contingent.[156] The proposed sale would yield a dividend to creditors of only 12 cents on the dollar. A group of U.S. creditors holding Aus $300 million in claims proposed a competing bid because they felt the sale price was too low; and their proposal featured the upside potential of an equity distribution.[157] Most of the shareholders were individual investors and voted with the administrators' proposal. However, creditors with claims totaling Aus $600 million voted against the administrators' proposed sale, while only Aus $320 million voted in favor, including the shareholders.[158] Under Australian law, where a vote splits, the administrator casts the deciding ballot and notwithstanding that the majority of claimants by value vote against the sale, the administrator's vote is determinative.[159] The case, while still pending, illustrates how recognition of such claims may affect the outcome of insolvency proceedings, and raises new questions in respect of fairness in the claims valuation and voting process. Here, the process recognizing shareholder claims on a *pari passu* basis worked to advance the insolvency professional's proposed sale, but did so against the express wishes of creditors holding the vast majority of claims by value.

Shortly after the High Court's judgment was rendered, the Australian government directed the Corporations and Markets Advisory Committee to study three issue in respect of equity claims, specifically: (1) should shareholders who acquired shares as a result of misleading conduct by a company prior to its insolvency be able to participate in an insolvency proceeding as an unsecured creditor for any debt that may arise out of that misleading conduct, (2) if so, are there any reforms to the statutory scheme that would facilitate the efficient administration of insolvency proceedings in the presence of such claims, and (3) if not, are there any reforms to the statutory scheme that would better protect shareholders from the risk that they may acquire shares on the basis of misleading information?[160]

From a public policy perspective, one of the most helpful aspects of the *Sons of Gwalia* judgment is that it has assisted in sparking a broader public policy discussion

156. Evan Flaschen, "Australia: The Sins of the Sons (of Gwalia) are Visited on Creditors Yet Again", Bracewell & Giuliani Newsletter, 27 July 2007, http://www.bracewellgiuliani.com/index.cfm/fa/news.advisory.print/item/2108cb12-96f3-40bb-8. Flaschen reports that some of these claims included claims for "lost opportunity damages", such as, if the investor had known of the fraud he or she would have invested in another company and hence the investor lost the amount of profits made by that other company. He reports that shareholders were deemed for voting purposed to hold Aus $250 million of the Aus $1.1 billion of claims eligible to vote.

157. *Ibid.* at 2.

158. *Ibid.*

159. This is in contrast to U.S. or Canadian law, whereby a vote by creditors to against the proposed sale would be sufficient to defeat it.

160. Chris Pearce, MP, Parliamentary Secretary to the Treasurer, http://parlsec.treasurer.gov.au/cjp/content/pressreleases/2007/002.asp (February 7, 2007). The committee's deliberations are still pending as this paper goes to press.

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regarding subordination of claims that arise from statutory violations. Such claims are clearly distinguishable from equity claims arising in the course of firm insolvency, for which there is broad global consensus regarding their placement of the hierarchy of satisfaction of claims. Given that securities law and insolvency law regulate different aspects of the provision of capital to business, it is important that there be a balance in how their policy goals and substantive remedies are realized when the two schemes intersect. How they are to be reconciled requires further public policy discussion.

One final aspect of this subordination debate is the treatment of claims where they have elements of equity or options for investment of equity, but are not held by shareholders *per se*, as discussed in the next part.

F. Subordination of stock-based compensation claims

A sub-issue issue that has arisen in the U.S. is the status of stock-based compensation claims where a debtor corporation becomes insolvent. Two recent U.S. appellate cases have addressed the treatment of claims where company executives had stock-price-based unpaid compensation claims, arriving at different results.

In re Med Diversified Inc., the trustee sought a court order subordinating the claim of an executive whose severance package included the corporation agreeing to exchange its stock for stock owned by the departing executive in another company, an exchange that did not occur before the corporation filed for bankruptcy.[161] The Second Circuit Court of Appeals held that the claim was subordinated, and that § 510(b) of the U.S. *Bankruptcy Code* intended to subordinate those claims where the claimant took on the risk and return expectations of an equity investor or seeks to recover a contribution to the equity pool that is presumably relied on by creditors in their lending decisions. The Court held that by trading the relative safety of cash for the upside potential of shareholder status, the executive's potential benefit of being a stockholder was sufficient to subordinate the claim under § 510(b). He had bargained for status as a shareholder rather than a creditor.[162] The Court observed that this reasoning is similar to *Betacom*, in which the court held that there are two main reasons for subordination of a claim pursuant to § 510(b), the dissimilar risk and return expectations of creditors and shareholders; and the reliance of creditors on the equity cushion provided by shareholder investment.[163] In *Med Diversified*, the first policy rationale was found, and the Court held that it was not troubled by the fact that the equity-cushion rationale was not directly applicable.[164]

In contrast, in *re American Wagering Inc.*, the Court of Appeals for the Ninth Circuit held that a financial advisor whose promised compensation for assisting with the

161. In re Med Diversified, Inc. (2006) 461 F. 3d 251 (2nd Cir.).

162. Ibid. at 256. See also *In re Enron Corp.*, 341 B.R. 141, 162-63 (Bankr. S.D.N.Y. 2006), which subordinated the claims arising from ownership of employee stock options, on the basis that the cash value of the options varied with the value of the debtor's stock and to that extent resembled a typical equity interest.

163. American Broadcasting Sys., Inc. vs. Nugent (*In re Betacom of Phoenix, Inc.*), 240 F.3d 823 (9th Cir. 2001); see also *In re American Wagering Inc.* (2006) 465 F. 3d 1048 (9th Cir.).

164. In re Med Diversified, Inc. (2006) 461 F. 3d 251 (2nd Cir.) at 259.

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debtor's initial public offering was to be paid in the form of shares in the debtor company, when he successfully sued for the cash equivalent value of his claim, should not have his claim subordinated under § 510(b).[165] The Court held that he did not sue the debtor as an equity investor seeking monetary damages for fraud or breach of contract; rather, he sued as an agent that did not receive promised compensation under an employment agreement. The Court of Appeals held that the monetary judgment awarded initially, before the bankruptcy, established a fixed pre-petition debt owing the financial advisor as a creditor, and that he was not in the position of risk or return equity investor and hence he should be treated as an ordinary unsecured creditor.[166]

It is unclear that the cases can be reconciled based on the nature of the claim and whether it resembles the risk and returns associated with shareholder investment. Where the claim is clearly a debt, as in a judgment for cash making the claimant a judgment creditor, then the court may not subordinate the claim. That was a key part of the court's reasoning in *re American Wagering Inc.* However, the main rationale in *re Med Diversified Inc.* appears to apply in *re American Wagering Inc.* in that the consultant took the equity risk rather than cash. One question is why the timing of the court's decision should determine whether the party is a creditor or an equity investor. If the claim is subordinated in one instance and not the other, there may be a rush to litigation where claimants seek to protect their interest and outpace the filing of any insolvency proceeding, which in turn may deter these types of compensation arrangements or the settlement of such claims. On the other hand, litigation is slower than a decline into insolvency, and hence this may not ultimately be a material concern.

The debate in various jurisdictions regarding the treatment of claims arising out of securities law violations continues to be unresolved. The next part discusses several policy options that attempt to reconcile the tensions arising out of the conflict in priority of claims under the different public law regimes.

III. Policy Options Regarding the Treatment of Claims Arising Out of Securities Law Violations

While there is a need for greater certainty in respect of how claims for securities law violations are to be treated, the solution is not immediately evident. This part commences a discussion of some of the potential options for dealing with such claims.

In developing a framework that would support the public policy goals of both securities law and insolvency law, one needs to consider the nature of the harms for which damages are sought. For example, fraud is a particularly egregious harm. Misrepresentation, however, can be intentional, with the intent to defraud investors, or it can be a violation based on timeliness of disclosing information to the market.

165. *In re American Wagering Inc.* (2006) 465 F. 3d 1048 (9th Cir.).

166. For a comment on these cases and on how compensation should be structured, see A. Ostrow and C. Pourakis, "Taking Stock of Unpaid Compensation Claims, How to Avoid Losing Rights Based on Stock Value when the Stock Falls to Zero in Bankruptcy", Stevens & Lee Newsletter (10 January 2007).

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This latter type of misrepresentation is a harder issue in terms of thinking about remedies arising from misconduct. There can be considerable uncertainty in respect of the scope of continuous disclosure requirements, both in terms of content of the disclosure and in the timing of such disclosure such that ephemeral information is not unnecessarily disclosed to the market.[167] While securities law mandates timely disclosure, in practice, there are difficult decisions in respect of what is material or sufficiently crystallized such that it should be disclosed.[168] Thus, another question is just how timely a publicly traded debtor corporation must be in disclosing its financial distress such that shareholders can decide to buy, sell, or hold based on that expectation of decline, and such that their future claims rank equally with unsecured creditors. Moreover, where does business judgment in regard to timing of disclosures and deference to that judgment fit into the overall scheme of how such issues are to be treated? A non-insolvency case on precisely this issue is currently pending before the Supreme Court of Canada.[169]

Whatever policy option is considered, it must be measured against its effect on both debt and equity markets, as it may affect both investor confidence and the price of credit, as well as the transaction costs of both litigation and of valuing claims that arise during insolvency proceedings. The subordination of an equity claim does not facilitate a restructuring unless the issue of voting rights is also addressed, because securities claimants would form a class that could veto a proposed restructuring plan, absent clear statutory language preventing such an outcome.[170] Litigation involving claims of this type is complicated and slow. If there is a class action that hasn't been certified, the case can take a very long time.

It is also important to note that most debtor companies have not engaged in misrepresentation or deceptive conduct, such that their insolvency will give rise to securities law claims. A hallmark of both statutory schemes is transparency, certainty, and efficiency, objectives that should be borne in mind in considering policy options.

One possible policy option is that only new purchasers of securities under either primary offerings or secondary market purchases would have claims arising from securities law violations ranked equally with unsecured creditors, on the basis that the purchaser of an equity investment would not be a shareholder in respect of the investment but for the company misstating its financial status. In support of this option, one could argue that existing shareholders arguably have access to information such that they can be monitoring their risk and making timely decisions to buy more equity, hold or sell their investment. The difficulty with this policy option is that, for the most part, today's shareholders are not insiders; they are a widely dispersed group that does not have the time, resources or capacity to monitor corporate

167. Janis Sarra, 'Modernizing Disclosure in Canadian Securities Law: An Assessment of Recent Developments in Canada and Selected Jurisdictions', Study for the Task Force to Modernize Securities Legislation in Canada (Toronto, IDA, 2006).

168. An example would be early discussions regarding merger.

169. *Kerr vs. Danier Leather Inc.* 77 O.R. (3d) 321 (Ont. CA), leave to appeal to SCC granted and judgment pending.

170. For example, if another court were to follow the Canadian court judgment in *Blue Range* and decide on equitable principles to subordinate an equity claim behind unsecured creditors, the result would be that the equity claim would get a veto over the restructuring.

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officers. Their decision to hold or sell is based on the disclosures being made by the corporation in any new offerings or under continuous disclosure obligations. While their claims arising from ordinary business risk are those that they have willingly accepted, this approach does not deal with the distinction of remedies for statutory violations.

One difficulty with the company having to pay for the damages under this option as if investors were creditors is that existing equity investors that have been similarly harmed suffer the consequences of both the original harm and then further losses as assets are directed to compensate claimants, assuming that is any equity left at the point of insolvency proceedings. Moreover, if a key objective is deterrence of misconduct, the fact that the assets of the company are used to compensate for damages may not be the optimal approach to deterrence of officers' conduct. This policy option fails to make the distinction between new purchasers purchasing in the secondary market, where the company only indirectly benefits from the misconduct (absent fraud) and new purchasers in the primary market.

The second option is similar to the first, but would rank new purchasers equally with unsecured creditors only where there were violations of primary offering requirements of securities law. This option is premised on the fact that violations of securities law in primary markets offerings results in a benefit accruing directly to the company. Secondary market violations do not result in any money directly to the corporate treasury. Arguably then, investors should seek remedies directly from the corporate officers that engaged in the misconduct, and then those officers could pursue the corporation if indemnity was available for the particular misconduct. This option would assist in maintaining the integrity of primary markets by ensuring that prospectuses are accurate and timely in their disclosures. However, to treat primary market and secondary markets differently where there is a violation of securities law may be difficult to justify on public policy grounds, not withstanding the temptation to try to scope the availability of such remedies during insolvency, given that this distinction is not made outside of insolvency. Moreover, the introduction of short form prospectuses and the seasoned issuers requirements in the U.S., Canada, and other jurisdictions means that the lines between primary and secondary markets is blurring such that the same disclosure information is applied for securities issued and resold, and hence there is a question as to why claims from securities law violations should be distinguished based on primary or secondary markets.[171]

Another option is to grant securities regulators enhanced powers such that disgorgement of funds and penalties paid for misconduct can be directed towards investors harmed by the misconduct of the debtor corporation or its officers, as has occurred in the U.S. While this does not allow equity investors to realize directly on their claims, it does offer some financial relief from the harms caused. In such a model, the securities regulator serves a gatekeeping function that ensures that only meritorious claims are advanced and that securities claims are not inappropriately

171. See the discussion in Sarra, *supra*, note 167 regarding WKSIs in the U.S. and the blurring of primary and secondary market disclosure requirements.

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used by shareholders to leverage their position or their voice and control rights during insolvency proceedings. The difficulty is that securities regulators may determine that the harms caused in a particular case do not merit their resources being directed toward enforcement, leaving those equity investors without a remedy. Moreover, few, if any, jurisdictions have committed the resources and energy to securities enforcement that the U.S. has, and hence such an option in other jurisdictions may be less meaningful or effective.

The fourth option would be to treat all shareholder claims arising out of securities law violations as unsecured creditor claims on the basis that these liabilities are remedies to which investors are entitled under various statutes providing protection to investors. It is unclear that there has been a cogent public policy rationale advanced for the proposition that shareholders and creditors should be treated differently in respect of securities laws violations where neither contracted for fraud risk and frequently neither have the capacity to monitor against such risk. It also seems unclear why jurisdictions are moving on the one hand to enhance the remedies available to securities holders for corporate misconduct and on the other hand proposing that if the conduct is sufficiently egregious that satisfaction of claims makes the company insolvent, then the claims are completely subordinated to other interests in the firm. Parity in treatment of claims arising from statutory violations would remedy this problem.

While such claims under this option may initially be contingent, they arguably crystallize on insolvency and they would have to be provable and quantifiable. There are a number of consequences that would have to be considered in order to design a framework that was expeditious and fair for the valuation and resolution of such claims. In some jurisdictions, for example, there is the issue of causation, which is time-consuming and expensive to determine and which would slow the resolution of securities law claims in insolvency proceedings considerably. Hence, this option could result in insolvency proceedings grinding to a near halt, which in turn may result in value lost for all stakeholders with an interest in the firm. Moreover, claimants seeking remedies may suffer litigation fatigue and loss of even greater resources as they try to establish their claims. Yet the challenges for designing a system for the expeditious determination of claims arising out of securities law violations should not be a bar to recognizing these claims, just as product liability or other tort claims are treated as unsecured claims. It is unclear why damage claims arising from securities law violations should be subordinated when other types of tort claims are not; and this discrepancy in treatment is an issue that needs to be addressed by legislators. Most critically for the resolution of securities law claims within insolvency proceedings is whether there is a mechanism that can determine the validity and value of claims in an expeditious manner that would still allow equity claimants to participate in insolvency proceedings.

The fifth option is of course complete subordination of all claims, as is proposed in Canada and as is the law under the U.S. *Bankruptcy Code*, subject to the *Sarbanes-Oxley Act* fair funds provision as discussed above. While this option has a certain simplicity

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that creditors would find reassuring, it fails to address all the difficulties highlighted throughout this paper.

One of the unknown factors in considering all of these options in respect of Canadian law is that the secondary market civil liability regime is so new that it is difficult to determine how easily it will or will not be to establish damages for violation of securities law requirements. Under the recent Canadian legislation, there is no requirement to establish reliance, but there is a cap on the amount that individuals can be found liable for any failure to disclose or misrepresentation. There is no cap on damages where fraud or intentional or authorizing misrepresentation or failure to disclose is proven.[172] Hence, the deterrence effects of particular options may also be limited. Moreover, as noted earlier, the Supreme Court of Canada has yet to rule on the issue of the amount of deference that will be given to business judgment in the context of complying with securities law disclosure requirements. In this sense, outright fraud is the easier issue to determine, than an issue such as misrepresentation of the issuer's financial situation or its future oriented financial prospects.

These options also reveal that conflation of remedies for deterrence or investor compensation for harms may not always be possible, and thus there are both tensions within securities law and tensions that arise when it intersects with insolvency law.

The next part examines a different aspect of the intersection of securities and insolvency law, specifically, the treatment of claims arising out of the insolvency of securities firms in insolvency. Unlike the subordination debate, the issues here arise in the context of tracing property claims. This framework involves issues quite distinct from the issue of subordination of claims, but it is an important aspect of reconciling the two regimes. Moreover, it raises some of the same questions in respect of whether the scheme adequately addresses the issue of fraud and other securities law violations in the course of insolvency proceedings.

IV. Special Provisions for Bankruptcy of Securities Firms

Given the exponential growth in capital markets in the past 50 years and the number of companies servicing the market, it was inevitable that there would be a greater number of securities firm failures. The insolvency of securities firms has unique challenges. Such firms often actively trade in large volume, and at any given point, a securities firm holds securities for customers in the form of securities in the name of the securities firm, with the customer as beneficial owner only; holds securities in the customer's name but endorsed such that the securities firm can trade at its discretion or at the customer's discretion; some hold securities in the customer's name and such securities are segregated; and/or the firm holds customers' cash arising at any given moment from the sale of securities or dividends received but not yet paid to the customer. Each of these types of holding raises issues in respect of whether they are held in trust for the specific investor. Moreover, the conduct of the firm in the

172. See for example, ss. 138.1, Ontario *Securities Act*, *supra*, note 100.

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period immediately prior to bankruptcy may give rise to particular actions by investors against the securities firm, particularly for misrepresentation or other conduct.

Previously, trustees in bankruptcy and other insolvency professionals were left to try to sort out which securities properly belonged to the bankruptcy estate and which were clearly those of the securities firm's customers. At common law, there were complex constructive trust and tracing rules, which in turn often had serious consequences for the size of the pool of assets available for satisfaction of creditors' claims. Investors would argue constructive trust or resulting trust, trying to fit their claims within the various tests for establishing an equitable remedy to their losses. Such customers often sought to trace their funds once in the hands of the securities firm. Such tracing was difficult, expensive and time consuming, as often the funds were commingled or absent such that tracing ownership was futile. Prolonged cases consumed judicial resources with little evidence of a just outcome for investors. In jurisdictions that attempted to utilize these common law doctrines, receivers, or other insolvency administrators would frequently be left holding securities whose value was uncertain or highly fluctuating, preventing the professional from timely disposition of the shares in order to maximize value to the estate. Considerable administrative time and expense was expended in trying to sort out the status of various customers' claims, the form of the securities, and the precise amount of assets available for distribution. Hence, the special statutory provisions enacted in several jurisdictions are aimed at streamlining and clarifying how to address securities firm insolvencies.

In Canada and the United States special statutory regimes for administering securities firm insolvency attempt to create an expeditious and timely means of dealing with such insolvencies. In Canada, the amendments were aimed at creating a completely codified regime, eliminating, for the most part, common law trust arguments, except where a customer's funds are registered in the customer's name.[173]

A. The Canadian regime

In Canada, Part XII of the *BIA* sets out a scheme to govern securities firm insolvencies.[174] Securities firm is defined as a person who carries on the business of buying and selling securities from or to a customer, whether or not as a member of an exchange, as principal, agent or mandatary, and includes any person required to be registered to enter into securities transactions with the public, but does not include a corporate entity that is not within the definition of corporation under the *BIA*.

Part XII was 'enacted to simplify and streamline the administration of a bankrupt securities firm's estate' because the administration of such bankruptcies had been 'time-consuming, complex, uncertain, and costly to both investors and creditors' and often raised trust and tracing concepts that proved difficult to determine.[175] One court observed that: 'often, while waiting for adjudication of these trust claims,

173. In Canada, the *Bankruptcy and Insolvency Act* (*BIA*) was amended in 1997 to add Part XII—Securities Firm Bankruptcies.

174. Section 253, *BIA*.

175. *Ashley vs. Marlow Group Private Portfolio Management Inc.* (2006) O.J. No. 1195 (Ont. S.C.) at para. 30.

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the trustee would have to continue to hold potentially volatile securities, whose value could plummet, while customers battled over their entitlement to them'.[176]

Under the statutory scheme, securities registered in a customer's name are returned to the customer, and all other cash and securities held by an insolvent securities firm are placed in a general customer pool, and then subsequently distributed on a *pro rata* basis to the firm's customers. The customer pool fund is paid out before any creditors are paid out of a general fund. The operation of Part XII is subject to the rights of secured creditors and nothing in Part XII affects the rights of a party to a contract, including an eligible financial contract[177] with respect to termination, set-off or compensation. Where a securities firm purchases blocks of securities; is registered as the holder of the securities in its own name; and subsequently allocates the securities to its clients, such securities do not constitute 'customer name securities' within the meaning of s. 253 of the *BIA*.

In addition to ordinary creditors, a petition for a receiving order against a securities firm can be filed by a securities regulator, a securities exchange, a customer compensation body such as the Canadian Investor Protection Fund (CIPF), or a receiver. The regulator, exchange, compensation body, or receiver can file the petition where the securities firm has committed an act of bankruptcy within the 6 months before the filing of the application and while the securities firm was licensed or registered by the securities commission to carry on business in Canada. It can also file a petition where a suspension of a securities firm's registration to trade in securities or suspension of membership in a registered securities exchange is in effect when an application is filed, which constitutes an act of bankruptcy if the suspension is due to the failure of the firm to meet capital adequacy requirements.[178]

Under Canadian insolvency legislation, when a securities firm becomes bankrupt, securities owned by the securities firm and securities and cash held by or for the account of the securities firm or a customer, other than customer name securities, vest in the trustee.[179] The trustee is to determine which of the securities in customers' securities accounts are to be dealt with as customer name securities; and advise customers with securities determined to be customer name securities of the determination as soon as possible.[180] 'Customer name securities' means securities that on the date of bankruptcy of a securities firm are held by or on behalf of the securities

176. *Ibid.*

177. *Ibid.*, within the meaning of subsection 65.1 (8), *BIA*.

178. Section 256, *BIA* a copy of the application must be served on the securities commission, if any, having jurisdiction in the locality of the securities firm where the application was filed.

179. Section 261 (1), *BIA*. Section 253 of the *BIA* specifies that 'Customer' includes (a) a person with or for whom a securities firm in Canadian insolvency legislation deals as principal, or agent or mandatary, and who has a claim against the securities firm in respect of a security received, acquired or held by the securities firm in the ordinary course of business as a securities firm from or for a securities account of that person for safekeeping or deposit or in segregation, with a view to sale, to cover a completed sale, pursuant to a purchase, to secure performance of an obligation of that person, or for the purpose of effecting a transfer, (b) a person who has a claim against the securities firm arising out of a sale or wrongful conversion by the securities firm of a security referred to in paragraph (a), and (c) a person who has cash or other assets held in a securities account with the securities firm; but does not include a person who has a claim against the securities firm for cash or securities that, by agreement or operation of law, is part of the capital of the securities firm or a claim that is subordinated to claims of creditors of the securities firm.

180. Section 260, *BIA*.

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firm for the account of a customer and are registered in the name of the customer or are in the process of being so registered, but does not include securities registered in the name of the customer that, by endorsement or otherwise, are in negotiable form.[181]

Where a customer is not indebted to a securities firm, the trustee is to deliver to the customer the customer name securities that belong to the customer.[182] Where a customer to whom customer name securities belong and who is indebted to the securities firm,[183] discharges their indebtedness in full, the trustee is to deliver to that customer the customer name securities that belong to the customer.[184] If such a customer does not discharge its indebtedness in full, the trustee may, on notice to the customer, sell sufficient customer name securities to discharge the indebtedness.[185] The trustee is then to deliver any remaining customer name securities to the customer.[186]

The trustee is given broad powers in respect of the securities, other than customer name securities. The trustee can exercise a power of attorney in respect of and transfer any security vested in the trustee; sell securities, other than customer name securities; purchase securities; discharge any security on securities vested in the trustee; complete open contractual commitments;[187] maintain customers' securities accounts and meet margin calls; distribute cash and securities to customers; transfer securities accounts to another securities firm; to the extent practicable, comply with customer requests regarding the disposal of open contractual commitments and the transfer of open contractual commitments to another securities firm; and enter into agreements to indemnify the other securities firm against shortages of cash or securities in transferred accounts; liquidate any securities account without notice; and sell, without tender, assets of the securities firm essential to the carrying on of its business.[188]

Where a securities firm becomes bankrupt and property vests in a trustee, the trustee must establish a customer pool fund, including securities obtained after the date of the bankruptcy, but excluding customer name securities and excluding eligible financial contracts to which the firm is a party.[189] The customer pool fund is to include cash, including cash obtained after the date of the bankruptcy, and dividends, interest and other income in respect of securities; proceeds of disposal of securities, proceeds of policies of insurance covering claims of customers to securities; for a securities account of a customer; for an account of a person who has entered into an eligible financial contract with the firm and has deposited the cash with the firm to assure the performance of the person's obligations under the contract,

181. Section 253, *BIA*.
182. Section 263 (1), *BIA*.
183. On account of customer name securities not fully paid for, or on another account.
184. Section 263 (2), *BIA*.
185. The securities are thereupon free of any lien, right, title or interest of the customer.
186. Section 263 (3), *BIA*.
187. Section 253 specifies that 'open contractual commitment' means an enforceable contract of a securities firm to purchase or sell a security that was not completed by payment and delivery on the date of bankruptcy.
188. Section 259, *BIA*. The trustee may act without the permission of inspectors until inspectors are appointed and thereafter with the permission of inspectors.
189. Section 261 (2), *BIA* that are held by or for the account of the firm (a) for a securities account of a customer, (b) for an account of a person who has entered into an eligible financial contract with the firm and has deposited the securities with the firm to assure the performance of the person's obligations under the contract, or (c) for the firm's own account.

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or for the firm's own securities account; and specified investments of the securities firm in its subsidiaries.[190]

The trustee is also to establish a general fund, which includes all remaining vested property. Cash and securities in the customer pool fund are required to be allocated in the following priority: for costs of administration to the extent that sufficient funds are not available in the general fund to pay such costs; to customers, other than deferred customers, in proportion to their net equity;[191] and to the general fund.[192] Deferred customer in this context means a customer whose misconduct caused or materially contributed to the insolvency of the securities firm. The trustee must seek court approval to treat a customer as a deferred customer.[193] Where the securities accounts of customers are protected by a customer compensation body that body can also apply to the court for a ruling that a customer should be treated as a deferred customer.[194]

To the extent that securities of a particular type are available in the customer pool fund, the trustee must distribute them to customers with claims to such securities, in proportion to their claims to such securities, up to the appropriate portion of their net equity.[195] Subject to that requirement, the trustee may satisfy all or part of a customer's claim to securities of a particular type by delivering to the customer securities of that type to which the customer was entitled at the date of bankruptcy.[196]

The Canadian legislation specifies treatment where property has been deposited with a securities firm under an eligible financial contract. Where a person has, under the terms of an eligible financial contract with the securities firm, deposited property with the firm to assure the performance of the person's obligations under the contract, and that property is included in the customer pool fund that person is to share in the distribution of the customer pool fund as if the person were a customer of the firm with a claim for net equity equal to the net value of the property deposited that would have been returnable to the person after deducting any amount owing by the person under the contract.[197]

190. Ibid.

191. 'Net equity means, with respect to the securities account or accounts of a customer, maintained in one capacity, the net dollar value of the account or accounts, equal to the amount that would be owed by a securities firm to the customer as a result of the liquidation by sale or purchase at the close of business of the securities firm on the date of bankruptcy of the securities firm, of all security positions of the customer in each securities account, other than customer name securities reclaimed by the customer, including any amount in respect of a securities transaction not settled on the date of bankruptcy but settled thereafter, less any indebtedness of the customer to the securities firm on the date of bankruptcy including any amount owing in respect of a securities transaction not settled on the date of bankruptcy but settled thereafter, plus any payment of indebtedness made with the consent of the trustee after the date of bankruptcy; section 253, *BIA*.

192. Section 262(1), *BIA*. Section 253 specifies that 'deferred customer' means a customer whose misconduct caused or materially contributed to the insolvency of a securities firm and section 258(1) specifies that: 'Where the trustee is of the opinion that a customer should be treated as a deferred customer, the trustee shall apply to the court for a ruling on the matter and shall send the customer a copy of the application, together with a statement of the reasons why the customer should be so treated, and the court may, on such notice as it considers appropriate, make such order as it considers appropriate in the circumstances'.

193. Section 258(1), *BIA*.

194. Section 258(2), *BIA*.

195. Section 262(1), *BIA*.

196. Section 262(2.1), *BIA*; the trustee may, for that purpose, exercise the trustee's power to purchase securities.

197. Section 262(1.1), *BIA*.

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In distributing the property in the general fund, priority is given to statutory preferred creditors, and then rateably to: customers, other than deferred customers, having claims for net equity remaining after distribution of property from the customer pool fund and any property provided by a customer compensation body, in proportion to claims for net equity remaining; where applicable, to a customer compensation body to the extent that it paid or compensated customers in respect of their net equity, and to creditors in proportion to the values of their claims; then rateably to creditors that engaged in reviewable transactions and hence are not eligible for a dividend in respect of a claim arising out of that transaction until all claims of other creditors have been satisfied;[198] and finally, to deferred customers, in proportion to their claims for net equity.[199] Hence, the distribution of property under the special provisions for securities firm bankruptcies mirror general priorities under Canadian bankruptcy legislation, but recognizes that the securities firm holds securities for customers and hence that these customers should be paid from a separate pool of capital and not fall within general unsecured creditors' claims. The addition of deferred customers, who are entitled only after the claims of other customers are met, ensures that those who cause the insolvency do not gain an advantage from their actions.[200] The trustee's actions are subject to notice provisions that mirror other sections of the legislation. The trustee of a securities firm is to send customers a statement of customer accounts.[201]

The Ontario Superior Court of Justice has affirmed that section 262(3)(b)(i) of the *BIA* gives a customer compensation body such as the CIPF, although unsecured, payment priority under the general fund over all other unsecured creditors.[202] The Court held that the compensation body had a right to be consulted and involved in negotiations for settlement, particularly important where the CIPF will have to pay off customers of the brokerage firm out of the fund.[203] Where the accounts of customers of a securities firm are protected by a customer compensation body, the trustee is required to consult the customer compensation body during the administration of the bankruptcy, and the customer compensation body may designate an inspector to act on its behalf.[204]

A customer may prove a claim after the distribution of cash and securities in the customer pool fund and is entitled to receive cash and securities in the hands of the trustee at the time the claim is proven up to the appropriate portion of the customer's net equity before further distribution is made to other customers, but no such claim is to affect the previous distribution of the customer pool fund or the general fund.[205] The provision is

198. Section 137, *BIA*.

199. Section 262(3), *BIA*. Section 254. (1) specifies: 'All of the provisions of this Act apply, with such modifications as the circumstances require, in respect of claims by customers for securities and customer name securities as if customers were creditors in respect of such claims. (2) Sections 91–101 apply, with such modifications as the circumstances require, in respect of transactions of a customer with or through a securities firm relating to securities'.

200. On a policy level, however, both deferred customers and reviewable transactions may contribute to a firm's insolvency, and it is unclear why one type of relationship or transaction is preferred over another in this provisions.

201. Section 257, *BIA*, together with notice.

202. *Re Thomson Kernaghan & Co.* (2003), 50 C.B.R. (4th) 287 (Ont. S.C.J. [Commercial List]). The CIPF is discussed below.

203. *Ibid.* at para. 3.

204. Section 264, *BIA*.

205. Section 265, *BIA*.

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aimed at ensuring timely claims to the securities. The trustee is then to prepare a statement indicating the distribution of property in the customer pool fund among customers who have proved their claims and the disposal of customer name securities; or any other report relating to that distribution or disposal that a court may direct.[206]

Hence, the legislation recognizes that securities firms hold the capital of customers and that they are entitled to return of their money to that extent on a *pro rata* basis before unsecured creditors.

The cases under Canadian law highlight the tension between creditors and securities holders in bankruptcy, although for the most part, the statutory provisions appear to have streamlined and clarified how assets are to be dealt with. In particular, the first cases have been primarily disputes with respect to the composition of the customer pool, because making assets available to securities holders means they are not available to meet creditors' claims.

In *Re Vantage Securities Inc.*, a bankrupt securities firm held certain monies in trust for the plaintiff pursuant to a contractual arrangement unrelated to its securities business.[207] The plaintiff sought to exclude the property based on trust provisions under the *BIA* that specify that trust property held by a bankrupt does not form part of the bankrupt's assets. The trustee in bankruptcy denied the claim on the basis that cash under Part XII meant all cash, including trust cash and that pursuant to s. 255 of the *BIA*, which specifies that where provisions in Part XII are in conflict with any other provision of the *Act*, they take precedence.[208] The British Columbia Supreme Court, in affirming the trustee's decision, held that on the plain reading of the statute, the section did not exclude trust property. The Court held that by enacting Part XII, Parliament's objective was to simplify the resolution of trust claims from customers of securities firms and to simplify securities firm bankruptcies by eliminating the myriad of competing trust claims and the associated legal costs and time delays.[209] It held that the amendments were aimed at removing the entire concept of trust law for securities except where those securities are customer named securities and cash when the bankrupt company was a securities firm.[210] The Court held that pursuant to s. 261 (1), all cash vested in the trustee, not just cash beneficially owned by the firm.[211]

In another Canadian judgment, *Re Marchment & Mackay Ltd.*, a bankrupt stockbroker firm, after lengthy litigation with securities authorities, had its license revoked and subsequently made an assignment in bankruptcy.[212] Section 262 of the *BIA* exposes the customer pool funds to the costs of administration of the estate in bankruptcy, given that securities other than customer name securities vest in the trustee. The maximum amount that can be paid out to a customer of a bankrupt for 'direct out

206. Section 266, *BIA*.

207. *Re Vantage Securities Inc.* (1998) 64 B.C.L.R. (3d) 148; 9 C.B.R. (4th) 169 (B.C. S.C. [In Chambers]).

208. Section 255, *BIA* specifies: 'All the provisions of this Act, in so far as they are applicable, apply in respect of bankruptcies under this Part, but if a conflict arises between the application of the provisions of this Part and the other provisions of this Act, the provisions of this Part prevail'.

209. *Ibid.* at para. 10.

210. *Ibid.* at para. 12. The Court held that for all other real or personal property held by a bankrupt securities firm, trust principles continued to apply.

211. *Ibid.* at para. 13.

212. *Re Marchment & Mackay Ltd.* (2000), 16 C.B.R. (4th) 247 (Ont. S.C.J. [Commercial List]).

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of pocket losses' under the requisite trust plan is Cdn $5000.[213] The Court was satisfied that this amount was Cdn $5000 and not Cdn $5000 less amounts that may be recovered otherwise than out of the trust plan.[214] The Court held that the plan should be given a purposeful, fair, and liberal interpretation, observing the unique nature of the customers' loss in that the securities and cash were rightly assets to which they would be unquestionably entitled to but for the assets vesting in the trustee under Part XII. The Court held that by filing a voluntary assignment in bankruptcy, the bankrupt brokerage firm put securities that had been ordered and not delivered beyond the bankrupt's ability to follow further customer directions as such securities vested in the trustee.

In *Ashley v. Marlow Group Private Portfolio Management Inc.*, the Marlow group of companies had operated as securities and investment dealers and investment advisers.[215] It was placed into receivership when more than Cdn $3 million disappeared from clients' trust accounts and its operations were suspended by the Ontario Securities Commission. The receiver was to identify and secure the assets, quantify the losses and determine the distribution of the remaining funds. A number of issues arose in the case, including, whether securities were being held in trust and thus should be returned to investors; whether Marlow Group's situation should be administered through a bankruptcy proceeding; and whether Marlow Group was in fact a securities firm within the meaning of Part XII of the *BIA*, because buying and selling securities was allegedly not Marlow Group's primary business activity, rather investment advice was. The receiver sought direction on placing the assets into the customer pool.[216]

The Ontario Superior Court of Justice considered the issue of what is a securities firm. In Canada, French, and English versions of the statutory language have equal authority, and here, the definition of securities firm did not completely align in its language. In comparing the French and English versions of the statutory provision, the Court found that the English version contained the phrase 'carries on the business', suggestive of being one's primary business, whereas the French version was silent on this language.[217] The Court held that a reasonable interpretation of the definition was that it included a corporation that buys and sells securities as part of its business, not that it had to be its primary business.[218] Thus, the broad definition

213. The Ontario Securities Commission requires as a condition of brokerage registration that securities firms enter into a trust agreement for the general purpose of protection of customers of securities firms, *ibid.* at para. 3.

214. *Ibid.* at para. 4. The Court observed that the thrust of the limitation is to avoid a double recovery for a specific item of loss; here, recovery from Marchment's estate in bankruptcy of other items was not a double recovery.

215. *Ashley vs. Marlow Group Private Portfolio Management Inc.*, 2006 CarswellOnt 3449 (2006) O.J. No. 1195, 19 C.B.R. (5th) 17 (Ont. S.C.J. [Commercial List]).

216. Some of the securities claimants sought the return of their securities to avoid inclusion in the pool, in order that they would receive 95% of the value of their claims, compared with 60% of value if included in the customer pool.

217. Section 253, *BIA*.

218. Relying on section 18 of the Canadian *Charter of Rights and Freedoms*, the Court held that both versions were equally authoritative that the French version formed part of the context in which the English version needed to be interpreted, and the court's role is to find a common interpretation. The Court held that the reference to 'including any person required to be registered' meant that the definition was not limited to such persons.

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of 'securities firm' was determined to be unambiguous, and a corporation that buys and sells securities as part of its business falls under the definition of securities firm and is subject to the application of Part XII.[219] The Court also held that since the provisions applied equally to cash and securities, accordingly, 'all securities held by the securities firm at the date of bankruptcy vest in the trustee, not just the securities owned beneficially by the firm'.[220] The only exclusion from the pool is the customer name securities. Section 255 specifies that to the extent that Part XII conflicts with other provisions of the *BIA*, Part XII prevails; and since cash and securities held in trust for the benefit of customers vest in the trustee, then Part XII prevails over the *BIA* trust provisions and trust claims are prohibited.[221] The Court also dismissed the receiver's motion for substantive consolidation based on concern about the lack of evidence of the effect on all creditors if there was substantive consolidation; however it held that the estates were to be procedurally consolidated and administered together.[222]

Another issue in *Ashley v. Marlow Group Private Portfolio Management* was whether units in a limited partnership could be re-registered in the claimants' names before assignment into bankruptcy in order to qualify them as customer name securities holders.[223] The Court determined that the corporate defendant held the units in trust for the claimants, which placed them in the same position as the other securities that were not customer name securities, and as they were not the subscribers, the Court concluded that there was no basis to require the register to be altered. Thus, all of the disputed assets were found to be part of the customer pool fund.[224]

In *Re White*, the claimant sought a declaration that it was the beneficiary of a constructive trust, as its money had flowed through a third party to the bankrupt.[225] It sought recovery of trust monies from the estate of the bankrupt. The Registrar observed that for purpose of the application, the bankrupt was likely involved in a ponzi scheme that collapsed shortly after the money had been transferred.[226] The Registrar held that while the transaction in question involved a security, there was no evidence that the defendant, though registered to sell securities, was carrying on business as a securities firm, and thus the definition of securities firm was not met and Part XII was not applicable. The Registrar also found that the situation did not warrant the imposition of a constructive trust or finding of unjust enrichment as there was not sufficient evidence of wrongful conduct to engage the court's conscience and in the circumstances, it was not appropriate to alter the *BIA* scheme of distribution.[227]

219. The court interpreted 'recorded' as including situations where there is another specified method of recording ownership, such as limited partnerships.

220. *Re Marchment & Mackay Ltd., supra,* note 212 at para. 60; and citing section 261, *BIA*. The Court held that on a plain reading of the statute that 'held for a customer' meant cash and securities held in trust or for the benefit of a customer.

221. Part XII prevails over s. 67 trust provisions.

222. *Ashley vs. Marlow Group Private Portfolio Management Inc.* (2006), 22 C.B.R. (5th) 126 (Ont. S.C.J.), at paragraphs 78, 79.

223. *Ibid.* at para. 67.

224. *Ibid.* at para. 67. According to the Limited Partnership Agreement and the *Limited Partnership Act*, it was required that the names and addresses of the limited partners be registered on the records of the limited partnership, and according to the Prospectus, a partner was entitled to request that the shares be registered in his/her name.

225. *Re White*, 2006 WL 3004129, 2006 CarswellOnt 6424 (Ont. S.C.J.) (Registrar).

226. *Ibid.* at para. 16.

227. *Ibid.* at paragraphs 20, 24.

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Portus Alternative Asset Management Inc. is the most complex case to date involving the special statutory scheme for insolvency of securities firms.[228] It involved the collapse of a related group of corporations, the Portus Group, whose affairs were substantially intertwined and extremely complex. One aspect of the case involved a motion by a group of investors for segregation of the assets of their fund for their benefit, rather than have their fund be a part of the bankruptcy of Portus Alternative Asset Management ('PAAM'). PAAM was the investment advisor to the Market Neutral Preservation Fund ('MNPF'), which was an open-ended trust in which units were sold to accredited investors through various registered market intermediaries without a prospectus, in reliance on prospective exemptions available under Ontario securities legislation.[229] MNPF used the Cdn $19 million from sale of its units to purchase the Canadian Basket, a basket of non-dividend paying Canadian securities listed on the Toronto Stock Exchange (TSX). The Canadian basket was pledged as security to Royal Bank of Canada ('RBC') for the obligations of MNPF under a forward contract.[230] The MNPF was not in the name of Portus, nor in its care; the account was held at another financial institution that was designated as prime custodian of the assets. The only role that PAAM played in the MNPF structure was as investment adviser.

Also implicated in the case was the MNB Trust, which was an open-ended trust in which RBC was the sole unitholder, owning all outstanding 1.9 million units; and for which PAAM was the trustee and Portus Asset Management Inc. ("PAM"), the investment manager. Under the terms of the forward agreement between MNPF and RBC, RBC agreed to pay to MNPF on maturity an amount equal to the redemption proceeds of units in the MNB Trust in exchange for the delivery of the Canadian Basket by MNPF to RBC.[231] In order for MNPF to realize value, the MNB Trust was required to dispose of its assets for cash and then distribute the net asset value to RBC as its sole unitholder; and pursuant to the forward contract, RBC was to deliver the net asset value of the MNB Trust units held by it to MNPF and it in turn would deliver the Canadian basket to RBC.[232] The complex structure was conceived to maximize investment return while minimizing the tax impact.[233] Funds did not flow as intended under various agreements and subsequently, almost Cdn $3 million in funds was diverted and disappeared. A cease trade order was issued and a receiver was appointed in respect of PAAM, PAM, and related entities in 2005, and the assets subject to receivership included the MNPF investment structure and a managed

228. *Ontario (Securities Commission)* vs. *Portus Alternative Asset Management Inc.* (2006), 19 C.B.R. (5th) 17 (Ont. S.C.J. [Commercial List]) at para. 3.
229. *Ibid.* at para. 9. The MNPF investors subscribed approximately Cdn $19.2 million.
230. The RBC forward contract was entered into between RBC and MNPF pursuant to which the RBC was to pay to MNPF, on the maturity date or pre-settlement date, as applicable, an amount equal to the redemption proceeds of units of MNB Trust in exchange for the delivery by MNPF to RBC of the Canadian basket, *ibid.*, Appendix, para. 18.
231. *Ibid.* at para. 11.
232. *Ibid.* at para. 11.
233. *Ibid.* at para. 14.

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account structure (MAS).[234] A further judgment ordered that the assets were to be dealt with in one bankruptcy proceeding.[235]

A key issue was whether one group of investors, the Market Neutral Preservation Fund investors ('MNPF Investors') was entitled to segregation of the assets of the MNPF for their benefit or whether the assets should form part of the bankruptcy of PAAM, in which case the MNPF investors would be treated the same as the other investors.[236] The MNPF Investors sought to avoid the customer pool and realize on the MNPF assets. The MNPF assets were managed by PAM.[237] While the Market Neutral offering was being conducted, PAAM began a distinct business by making its investment management services available to a less restricted class of investors by offering to manage the assets of any clients of third party dealers on a discretionary basis, rather than engaging in the direct sale of investment products like Market Neutral to accredited investors. Investors in this MAS class of investors executed an account application with PAAM and paid to it their investment money; however, the majority of these assets were deposited in the Market Neutral Account. The MAS did not provide investors with actual units in a specific fund, but rather, the investment management agreements specified that PAAM intended to invest all the assets in the account in a structure that was intended to provide investors with substantially the same economic effect of investment in a bank note trust series.[238] The MAS was not properly established, and more than Cdn $618 million was commingled with the MNPF account.

The Court declared that all the assets held by the various entities in the Portus group were property of PAAM and that all the people who invested with or through the debtor were customers within the meaning of Part XII of the *BIA*, preserving the rights of the MNPF investors to bring a claim asserting proprietary and tracing claims to the MNPF assets held in the name of PAAM.[239]

The Court accepted the general proposition as set out in *Vantage*, *supra*, and confirmed in *Marlow, supra* that the Canadian regime went as far as possible to eliminate competing claims by vesting most assets of a bankrupt securities firm in the bankruptcy trustee.[240] It held that the fact that the motion is made before, rather than during, bankruptcy was not determinative, as here there was a receiving order that placed control of assets in a receiver in circumstances where clearly bankruptcy was anticipated, and thus regard should be had to the effect on the result assuming bankruptcy. The determination during a receivership that contemplates bankruptcy should not produce a substantially different result from what would occur in bank-

234. *Ontario* (*Securities Commission*) vs. *Portus Alternative Asset Management Inc.* (*Receiver of*), (2005) O.J. No. 5548 (Ont. S.C.J. [Commercial List]).

235. *Ontario* (*Securities Commission*) vs. *Portus Alternative Asset Management Inc.* (2005) O.J. No. 6080 (Ont. S.C.J. [Commercial List]). With the court preserving the right of one group of investors to argue at a subsequent hearing that a particular set of assets did not form part of the bankrupt estate.

236. *Ontario* (*Securities Commission*) vs. *Portus Alternative Asset Management Inc.*, *supra*, note 194 at para. 2. At the initial date of receivership, Ontario bonds proceeds, SGP call options (collectively the 'MNPF Assets' were located in an account with RBC Dominion Securities Inc. ('RBC').

237. The trustee was Computershare Trust Company of Canada.

238. *Ontario* (*Securities Commission*) vs. *Portus Alternative Asset Management Inc.*, *supra*, note 220 at para. 32.

239. *Ibid.* at para. 36.

240. *Ibid.* at para. 100.

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ruptcy, given the public goals of Part XII of the *BIA*.[241] The Court held that the claims of the MNPF Investors commenced with an actual trust.[242] It held that while the provisions were intended to bring clarification, certainty and expedition to claims against securities firms, they were not intended to operate to defeat claims arising from a specific trust where those assets have been improperly commingled and could be traced.[243]

The Court in *Portus* accepted that Part XII of the *BIA* was enacted to overcome issues that arose in the context of the bankruptcies of securities firms by ranking investors equally against the customer pool fund and ranking investors ahead of others with respect to the cash and securities in the customer pool fund and that the broad public purpose behind the regime for securities firm bankruptcies was evidenced by the override of Part XII to other sections of the *BIA*.[244] However, the Court concluded that the position advanced by the MNPF Investors was not incompatible with the public purpose behind Part XII because the MNPF Investors were beneficiaries under specific contract and entitled to return of specific trust assets; PAAM was not a necessary party to the carrying out of the objects of that trust, it could have been any entity; the trustee duties of PAAM could have been carried out by a non-securities firm as trustee; the MNPF Investors were able to trace the assets of the MNPF Trust directly to the account at RBC;[245] and in performing trustee functions in respect of MNPF Investors, PAAM was not acting as a securities firm.[246] The Court held that it is not inconsistent with the public purpose of Part XII to exclude investor claims to which there is a clear, traceable contractual entitlement caught only because there is said to be the incidental involvement of a securities firm, when the transactions could have been lawfully and properly carried out by a non-securities firm.[247] Hence, the Court held that the MNPF Investors were entitled to the funds in the MNPF/Co. PAM Account in the name of PAAM as trustee and to the proceeds of the MNB Trust at RBC that could be segregated as being for the account of MNPF Investors.[248]

The Portus case is ongoing at the time this paper goes to press and numerous issues have yet to be resolved. The complexity of the corporate structure and the particular circumstances highlight, however, that statutory provisions that were created for ordinary securities law failures may not be entirely appropriate for cases in which

241. Ibid. at para. 101.

242. Distinguishing cases such as *Re Ivaco Inc.* (2005), 12 C.B.R. (5th) 213 and *General Chemical Canada (Re)* (2005) O.J. No. 5436 (QL), 2005 CarswellOnt 7306, in which claims arose in the context of a deemed trust, in the context of pension benefit claims, *ibid.* at para. 102.

243. Ibid. at para. 106, specifically, of s. 261 of the *BIA* and related sections.

244. Ibid. at paragraphs 107, 108, provided for in s. 255. The avoidance of the time and cost associated with resolution of complicated claims to priorities involving securities firms was a mandate in clear language in the statute; however, the question was whether s. 261 (1) has such broad reach that it should catch all transactions to which the section might apply, no matter how incidental they may be. *Ibid.* at paragraphs 111, 112.

245. Ibid., in which it held the MNPF Account as well as the MNB Trust.

246. The Court observed that the fact that PAAM happened to be a securities firm should not be conclusive, *ibid.* at paragraphs 113, 114.

247. Ibid. at para. 115. The Court noted that the circumstances in which a claim such as that of the MNPF Investors would arise is likely to be infrequent, based on particular facts, and that otherwise, the goal of Part XII could be impaired.

248. Ibid. at para. 120.

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the firm's failure is due to fraud or other securities law violations. The next cases will be critically important in determining whether the scope of the statutory language is sufficient to remedies harms created by misconduct or whether the courts will have to step in and exercise their gap-filling authority under the *BIA* to ensure that there are effective remedies for customers that have been harmed by securities law violations or criminal conduct.

In Canada, proposed amendments to insolvency legislation, if proclaimed in force, will clarify Part XII to specify that cash and securities covered by the provisions includes cash and securities held by any person for the account of the securities firm.[249] The objective is to clarify that all securities and cash, held by or for the securities firm, excluding customer name securities, are subject to the distribution rules in Part XIII of the *BIA*.[250]

Canada has established the CIPF as a mechanism to address losses to investors on insolvency of brokerage firms, and since its inception in 1969, CIPF has paid claims totaling $37 million to eligible customers of 17 insolvent member firms.[251] Funded by industry members, CIPF covers customers of members who have suffered or may suffer financial loss solely as a result of the insolvency of a member. Such loss must be in respect of a claim for the failure of the member to return or account for securities, cash balances, commodities, futures contracts, segregated insurance funds or other property received, acquired or held by the member in an account for the customer. Eligible claims may include the return of securities, cash balances, commodities, futures contracts, segregated insurance funds, or other property received, acquired or held by the member in an account for the customer. CIPF does not cover customers' losses that result from other causes such as changing market values of securities, unsuitable investments or the default of an issuer of securities. Claims that are eligible for coverage are normally settled by ensuring that the trustee has sufficient assets to transfer the customer accounts to another member and CIPF will return the customer's cash and securities, within limits, when a CIPF member becomes insolvent. As noted above, pursuant to the *BIA*, all customers share proportionately according to their net equity in the assets that make up the customer pool fund. If there is a shortfall, CIPF coverage is available to eligible customers.[252]

B. The U.S. scheme in respect of insolvent securities firms

The United States is another example of a jurisdiction that has enacted a special statutory regime for securities firm insolvencies. In the United States, the *Securities Investor Protection Act of 1970* (*SIPA*) was enacted to protect investors against financial

249. Section 261, proposed amendments to the *BIA*, Statutes of Canada Chapter 47, not yet proclaimed in force as of 15 June 2007.

250. Bill-55 (Chapter 47): clause-by-clause analysis, online: Strategis, http://strategis.ic.gc.ca/epic/internet/incilp-pdci.nsf/en/h_cl00790e.html.

251. http://www.cipf.ca/c_home.htm.

252. *Ibid.*

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losses arising from the insolvency of their brokers.[253] Although the U.S. *Bankruptcy Code* provides for a stockbroker liquidation proceeding, it is more common that a failed securities firm is addressed in a *SIPA* proceeding than a *Bankruptcy Code* liquidation proceeding.[254] Both regimes allows for the return of customer name securities.

The difference between liquidation under the U.S. *Bankruptcy Code* and the *SIPA* is that under the *Code*, the trustee is charged with delivering customer name securities, but then converting all other securities to cash expeditiously and making cash distributions to customers of the debtor securities firm in order to meet their claims. In contrast, a *SIPA* trustee is to distribute securities to customers to the greatest extent practicable, and to this end, there is a statutory grant of authority to the trustee to purchase securities to satisfy customers' net equity claims to specified securities.[255] Hence, *SIPA* is aimed at placing customers in as close a position as possible that they would have been had the firm not become insolvent. This is accomplished by seeking to preserve the investor's portfolio as it stood on the filing date.[256] Trustees appointed under the *Bankruptcy Code* do not have the resources to try to meet fully the claims, and hence their role is to protect the filing date value of the customers' securities by liquidating all non-customer name securities and distributing the cash.[257] Where customer names securities and Securities Investor Protection Corporation (SIPC) advances are not sufficient to satisfy the full net equity claims of customers, the customers are entitled to participate in the estate as unsecured creditors.[258]

The *SIPA* advances its statutory purpose by according those claimants in a *SIPA* liquidation proceeding who qualify as 'customers' of the debtor priority over the distribution of customer property.[259] Customer property is defined as cash and securities at any time received, acquired or held by or for the account of a debtor from or for the securities accounts of a customer, and the proceeds of any such property transferred by the debtor, including property unlawfully converted.[260] The trustee must promptly deliver customer name securities to the debtor's customers, distribute the fund of "customer property" to customers, and pay, with money from the SIPC fund, remaining creditors' net equity claims to the limits provided for.[261] As under the Canadian legislation, each customer shares ratably in the customer property fund of

253. *Securities Investor Protection Act of 1970*, 15 U.S.C. § 78 aaa *et seq.* (SIPA); *SEC vs. S.J. Salmon & Co.*, 375 F. Supp. 867, 871 (S.D.N.Y. 1974).

254. *Bankruptcy Basics*, Administrative Office of the United States Courts Public Information Series, April 2004 at 53.

255. *SIPA*, 15 U.S.C. §§78fff-2(d), *Ibid.* at 55. The trustee is required to deliver customer name securities if the customer is not indebted to the debtor; if the customer is indebted, the customer may, with approval of the trustee, claims securities in his or her name upon payment to the trustee of the amount of indebtedness, 15 U.S.C. §§ 78fff-2(c)(2) The trustee can also, with the approval of the SIPC, sell or otherwise transfer to another member of SIPC, without the consent of a customer, all or any part of the account of a customer, 15 U.S.C. §§78fff-2(f).

256. *Bankruptcy Basics, supra*, note 254 at 55.

257. *Ibid.*

258. 15 U.S.C. §§78fff-2(c)(1).

259. *SIPA*, 15 U.S.C. §§78fff-2(b) & (c)(1), 78lll (4). Customer is defined as: 'Any person... who has a claim on account of securities received, acquired, or held by the debtor in the ordinary course of business as a broker or dealer from or for the securities accounts of such persons for safekeeping, with a view to sale, to cover consummated sales, pursuant to purchases, as collateral security or for the purposes of effecting transfer. The term "customer" includes any person who has a claim against the debtor arising out of sales or conversions of such securities, and any person who has deposited cash with the debtor for the purchase of purchasing securities'.

260. *SIPA*, 15 U.S.C. §§78lll (4).

261. *SIPA*, 15 U.S.C. §§78fff-2(a)–(c).

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assets to the extent of the customer's net equity at the time of filing. If the fund of customer property is insufficient to make the customers whole, the fund created by the *SIPA* funds the difference up to a specified limit. The *SIPA* fund is capitalized by the general brokerage community.[262] The current limits of protection are set at U.S. $500,000 claim per customer for securities, and U.S. $100 000 per customer for cash.[263]

When a brokerage firm fails, the SIPC will arrange to have the brokerage's accounts transferred to a different securities firm; and if it is unable to arrange the transfer, the failed firm is liquidated.[264] The SIPC sends investors either the certificates for the securities that were lost or a cheque for the market value of the shares.[265] The commencement of a *SIPA* case is undertaken by filing an application for a protective decree with the U.S. district court, and if proceedings are granted, any pending bankruptcy liquidation proceedings are stayed until the *SIPA* action is completed.[266] The district court has the authority to grant a stay pending determination of the application for a protective decree, including actions pending under the bankruptcy proceeding, and it also has the discretion to appoint a temporary receiver.[267] The *SIPA* specifies that the district court will grant a protective decree if the debtor consents, the debtor fails to contest the application, or the district court finds one of four conditions specified in the *SIPA*.[268] Once a protective decree is granted, a trustee is appointed and the district court orders removal of the proceeding to the bankruptcy court in the same judicial district as an adversary proceeding for liquidation.[269] The bankruptcy court is to convene a hearing within 10 days, on notice to customers and creditors, on the disinterestedness of the trustee, where parties can object. If the SIPC is the trustee, it is deemed disinterested.[270] The objectives and process of a *SIPA* liquidation are described by the Administrative Office of the United States Court in the following way:[271]

> The purposes of a SIPA liquidation are: (1) to deliver customer name securities to or on behalf of customers, (2) to distribute customer property and otherwise satisfy net equity claims of customers, (3) to sell or transfer offices and other productive units of the debtor's business, (4) to enforce the rights of subrogation, and (5) to liquidate the business as promptly as possible. 15 U.S.C. § 78fff(a). To the extent possible, consistent with SIPA, the liquidation is conducted in accordance with chapters 1, 3, 5, and subchapters I and II of chapter 7 of Title 11. 15 U.S.C. §78fff(b). A section 341 meeting of creditors is conducted

262. *SIPA*, 15 U.S.C. §§78fff-3, 78ddd; *SEC vs. Packer, Wilbur & Co.*, 498 F.2d 978, 980 (2d Cir. 1974).
263. *SIPA*, 15 U.S.C. §§ 78fff-3. See also the Securities Investor Protection Corporation, *2005 Annual Report*, www.sipc.org.
264. The SEC is responsible for regulating and supervising the activities of the SIPC under its rule making power for self-regulatory organizations; *Bankruptcy Basics, supra*, note 254 at 60.
265. *Bankruptcy Basics, ibid.* at 53.
266. *Bankruptcy Code*, 11 U.S.C. § 742; *SIPA*, 15 U.S.C. § 78aaa *et seq.*
267. *SIPA*, at 15 U.S.C. §§78eee(b)(2)(B)(I-iv).
268. *SIPA*, at 15 U.S.C. §§78eee(b)(I).
269. The *Bankruptcy Basics* book issued by the Administrative Office of the U.S. Courts specifies that there are historical reasons for using an adversary proceeding, and that *SIPA* specifies that certain features under the *Bankruptcy Code* are applicable in *SIPA* proceedings, *supra*, note 254 at 56.
270. *SIPA*, at 15 U.S.C. §§78eee(b)(6)(A) and (B).
271 *Bankruptcy Basics supra*, note 254 at 57.

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by the trustee. Non-customer claims are handled as in an asset case. Costs and expenses, and priorities of distribution from the estate, are allowed as provided in section 726 of Title 11. Funds advanced by SIPC to the trustee for costs and expenses are recouped from the estate, to the extent that there is any estate, pursuant to section 507 of Title 11.

The trustee's powers under a *SIPA* liquidation are almost identical to those of a trustee in bankruptcy.[272] The trustee has responsibility for investigating the acts, conduct, and condition of the debtor securities firm and making a report to the court.[273] The trustee also reports periodically on its progress in distributing cash and securities to customers.[274]

The *SIPA* requires the SIPC to make advances to the trustee in order to satisfy claims, either in the form of cash to customers with claims or to purchase securities to satisfy net equity claims in lieu of cash, including the administrative costs of meeting these claims, up to a maximum of U.S. $500 000 per customer.[275] The SIPC can elect in particular circumstances to undertake direct payment to customers outside of bankruptcy proceedings; specifically, where the claims of all customers aggregate less than U.S. $250 000, the debtor is financially distressed as defined by law and the cost to the SIPC for a direct payment process is less than for liquidation through the courts.[276]

While there was only one firm failure in 2005 in which the SIPC had to intervene, in the past 35 years, it has commenced 314 proceedings of which 283 were completed by the end of 2005.[277] While not all proceedings were bankruptcy proceedings, all did involve firms in financial difficulty. Under the regime, the exchanges, the SEC, and the National Association of Securities Dealers report to SIPC concerning broker-dealers that are insolvent or approaching financial distress. If SIPC determines that it is necessary to act, it applies to a Federal district court for the appointment of a trustee.[278] In some circumstances, SIPC may pay customer claims directly as advances. Since the *SIPA* was enacted, cash and securities distributed for customers of broker-dealers in financial difficulty have totaled U.S. $14.1 billion, of which U.S. $13.8 billion came from debtors' estates.[279]

Customer-related property of the debtor is allocated in the following order: first to SIPC in repayment of any advances made to the extent they were used to recover

272. Those powers vested in a Chapter 7 U.S. *Bankruptcy Code* trustee.

273. *SIPA*, 15 U.S.C. §78fff-1(b)(2). The trustee also reports to SIPC and other persons as the court may direct.

274. *SIPA*, 15 U.S.C. §78fff-1(c).

275. *Bankruptcy Basics, supra*, note 254 at 59; 15 U.S.C. §78fff-3(a). If part of the claim is for cash, the total amount advanced cannot exceed USD 100 000, 15 U.S.C. §78fff-3(a)(1).

276. *SIPA*, 15 U.S.C. §78fff-4(a). The court could still be utilized to resolve disputes, but the process remains a transaction between the SIPC and the debtor's customers, without the expense of a trustee and court proceedings.

277. Securities Investor Protection Corporation, *2005 Annual Report, supra*, note 263 at 6. Twenty-six involved pending litigation matters and five involved claims still being processed. The one proceeding for 2005 was Austin Securities Inc. 314 represents less than 1% of the securities firms and broker-dealers in the U.S. In *Stephenson vs. Deutsche Bank AG, Deutsche Bank Securities Inc., Deutsche Bank Securities Limited, Wayne Breedon et al, Case No. CV02-4845 RHK/AJB (D. Minn.)* the trustee sued the Deutsche Bank-related entities and a Deutsche Bank stock-loan trader and others, in connection with an alleged massive securities fraud. The suit was joined by Ferris Baker Watts, Inc., E*Trade Securities, LLC, CIBC World Markets, Inc. and other securities firms. The trustee reached a settlement at a settlement conference before the magistrate judge, including agreement to withdraw claims, paying the trustee USD 147.5 million in cash. The settlement was approved by the bankruptcy court, and as a result of the settlement all the claims were to be paid in full; *SIPC vs. MJK Clearing Inc.*, Adv. Proc. No. 01-4257 RJK (Bankr. D. Minn. Jan. 18, 2006). The trustee also reached agreement with E*Trade with respect to the competing claims they both had in the bankruptcy case of Native Nations Securities, Inc., *ibid.* at 10.

278. *Ibid.* at 4.

279. *Ibid.*

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securities apportioned to customer property; second, to customers of the debtor on the basis of their net equities; third to SIPC as subrogee for the claims of customers; and fourth, to SIPC as repayment of advances made by SIPC to transfer or sell customer accounts to another SIPC member firm.[280]

The U.S. litigation arising out of securities' firm insolvencies has focused on whether claimants were customers within the meaning of the *SIPA*;[281] the validity of claims and the enforceability of guarantees post-liquidation;[282] issues of controlling persons in connection with related companies and liability under the alter ego doctrine;[283] potential liability of compliance principals under a bankruptcy;[284] potential liability of general partners in a bankruptcy;[285] and alleged fraudulent transfers.[286] SIPA requires the claimant to establish customer status by requiring that a debtor's obligations to its customers be 'ascertainable from the books and records of the debtor' or otherwise established to the satisfaction of the trustee.[287] The courts have generally given a narrow interpretation to the term 'customer' and required evidence of a timely written complaint in respect of the securities where the claimant believes that the trades were unauthorized.[288] However, the fact that the property is missing, for unauthorized trading or otherwise, does not affect customer status.[289]

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280. Bankruptcy Basics, supra, note 254 at 59.

281. Stafford vs. Giddens (In re New Times Securities Services, Inc.), Case No. CV-05-0008 (JS) (E.D.N.Y. 16 August 2005), reversed U.S. Court of Appeals for the second Circuit 463 F.3d 125, 2006 U.S. App. Lexis 22855; 47 Bankr. Ct. Dec. 13 2006; *Edward G. Murphy, Inc. Profit Sharing Plan, et al* vs. *Selheimer & Co. Inc. and SIPC* No. 02-6847 (E.D. Pa. 23 Feburary 2003); *In re Klein, Maus & Shire, Inc.* 301 B.R. 408 (Bankr. S.D.N.Y. 2003); *Arford vs. Miller (In re Stratton Oakmount, Inc.)* 210 F.3d 420 (2d Cir. 2000). These include failing to discharge the burden of proof in terms of timely objection in writing to alleged unauthorized trades (*In re Klaus, Maus & Shire, Inc.* 2002 Bankr. LEXIS 1786 (Bankr. S.D.N.Y.) and declining protection under *SIPA* in the absence of a claimant demonstrating that he or she met contractual obligations 'within a reasonable time of receipt of a trade confirmation of the transaction in question and/or monthly account statement in accordance with the instructions' (*In re Klaus, Maus & Shire, Inc.* 2002 Bankr. LEXIS 1784 (Bankr. S.D.N.Y.).

282. See for example, *Stephenson* vs. *Greenblatt et al.* (*In re MJK Clearing, Inc.*), 408 F.3d 512 (8th Cir. 2005).

283. Mishkin vs. Gurian (In re Adler, Colman Clearing Corp.), 399 F.Supp.2d 486 (S.D.N.Y. 2005), whereby the trustee sued Gurian for payment of USD 150 million in judgments that the trustee had obtained against numerous Bahamian shell companies allegedly used to commit securities fraud that ultimately led to the debtor's financial collapse. The Court held Gurian to be a controlling person of the companies under the common law doctrine of alter ego and the *Securities and Exchange Act*, section 20.

284. Lutz vs. Chitwood (In re Donahue Securities, Inc.), Case No. C-1-05-010 (S. D. Ohio, 6 September 2005), where the district court affirmed the decision of the bankruptcy court dismissing the trustee's claims against a compliance principal of the firm for negligent supervision and breach of fiduciary duty on the basis that the wrongdoer was the employer of the compliance principal and because the allegations were insufficient to establish a fiduciary relationship between Chitwood and the debtor's customers.

285. SIPC vs. Murphy (In re Selheimer & Co.), 319 B.R. 395 (Bankr. E.D. Pa. 2005); *Murphy vs. Selheimer (In re Selheimer & Co.)*, 319 B.R. 384 (Bankr. E.D. Pa. 2005); *SIPC vs. Murphy (In re Selheimer & Co.)*, Adv. Prc. No. 04-0669 (Bankr. E.D. Pa. April 12, 2005), appeal allowed, *Murphy vs. SIPC*, Civ. Action No. 05-2311 (E.D. Pa. Oct. 14, 2005).

286. Picard vs. Taylor (In re Park South Securities, LLC), 326 B.R. 505 (Bankr. S.D.N.Y. 2005), where the trustee sued on the basis of fraudulent transfers.

287. 15 U.S.C. § 78fff-2(b); *In re Klein, Maus & Shire, Inc.* 301 B.R. 408 (Bankr. S.D.N.Y. 2003) at 22.

288. Ibid., see also *In re Adler Coleman Clearing Corp.*, 204 B.R. 111, 115 (Bankr. S.D.N.Y. 1996); *In re A.R. Baron Co., Inc.*, 226 B.R. 790, 795 (Bankr. S.D.N.Y. 1998); *In re MV Securities, Inc.* 48 B.R. 156, 160 (Bankr. S.D.N.Y. 1985); *Schultz vs. Omni Mut., Inc.* (1993) Fed. Sec. L. Rep at 98 (S.D.N.Y. 1993).

289 *In re Klein, Maus & Shire, Inc.* 301 B.R. 408 (Bankr. S.D.N.Y. 2003) at 28; *In re Adler Coleman Clearing Corp.*, 198 B.R. 75 (Bankr. S.D.N.Y. 1996) at 75.

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For example, in *Stafford v. Giddens (re New Times Securities Services Inc.)*, the U.S. Court of Appeals for the Second Circuit reversed a judgment of the district court that had allowed claims under the *SIPA*.[290] In the aftermath of the bankruptcy of two brokerage firms, the plaintiffs claimed entitlement as customers as defined by *SIPA* to recover their losses from a ponzi scheme engineered by the principal of the firms, in which he pretended to invest in genuine money market funds and issued fraudulent promissory notes.[291] The plaintiffs had been induced to liquidate their accounts at the brokerage firm and make a loan to the brokerage firm. The trustee for the *SIPA* liquidation concluded that the plaintiffs were lenders, not customers, and denied their claims to *SIPA* funds. The bankruptcy court agreed with the trustee and the district court reversed. The Court of Appeals reversed again and remanded the case to the district court with instructions to reinstate the judgment of the bankruptcy court.

The Court of Appeals in *Stafford vs. Giddens* observed that judicial interpretations of customer status support a narrow interpretation of the *SIPA*'s provisions, drawing a distinction between customers and those in a lending relationship.[292] The Court held that whether an individual enjoys customer status turns on the transactional relationship; and that a loan unrelated to trading activities in the securities market does not qualify for *SIPA* protection. The Court held that the *SIPA* assumes that a customer, as an investor in securities, wishes to retain his or her investments despite the liquidation of the broker and that the statute is therefore aimed at exposing the customer to the same risks and rewards that he or she would have enjoyed had there been no liquidation.[293] The Court applied the principle that a customer's legitimate expectations at the date of filing determine the nature and extent of customer relief under the *SIPA*. The Court's determination of these expectations are informed by examining written confirmation of transactions and what customers expect to have in their accounts on the filing date.[294] The Court concluded that the plaintiffs had decided to swap their *SIPA*-protected securities investments for non-protected loan instruments and hence their only legitimate expectation must have been that they were lenders; and while they were defrauded, *SIPA* does not protect against all cases of alleged dishonesty and fraud.[295] It rejected the district court's conclusion that because the plaintiffs were fraudulently induced to invest in the promissory notes, their legitimate expectations froze at the moment their sold their securities. This situation was in contrast to that in another case, *In re New Times Securities Services*, because in the latter case, even though the securities were fictitious, the investors had a legitimate expectation that they had invested in securities.[296]

290. Stafford vs. Giddens (In re New Times Securities Services, Inc.), U.S. Court of Appeals for the Second Circuit 463 F.3d 125, 2006 U.S. App. Lexis 22855; 47 Bankr. Ct. 13 December 2006.

291. Ibid., citing *In re New Times Securities Services*, 371 F.3d 68, 71 (2d Cir. 2004).

292. Ibid., citing *In re Stalvey & Assocs., Inc.*, 750 F.2d 464, 472 (5th Cir. 1985); *SEC vs. F.O. Baroff Co.*, 497 F.2d 280, 282 n.2 (2d Cir. 1974); and *In re Hanover Square Sec.*, 55 B.R. 235, 238-39 (Bankr. S.D.N.Y. 1985).

293. Ibid. at 10.

294. Ibid., citing *Miller vs. DeQuine Revocable Trust (In re Stratton Oakmount, Inc.)* 2003 U.S. Dist. LEXIS 20459, No. 01-CV-2812 (S.D.N.Y. 14 November 2003).

295. Ibid. at 14.

296. Ibid. citing *In re New Times Securities Services* 371 F.3d at 71–72, 86.

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As a public policy matter, it is apparent that there could be greater public education such that investors better understand the risk and rewards of investing in capital markets and what preventive measures they might wish to consider minimizing their losses on securities firm insolvency. In the U.S., for example, investors should ensure that securities they purchase are registered in their name as soon as possible after their purchase. The difficulty with this preventive strategy is that often securities are never registered in the investor name, and although investors are the beneficial owners of the securities, they would still fall within the customer pool provisions of various statutory schemes. It is also important that investors deal with securities firms that are members of national protection funds, such as the CIPF in Canada or SIPC in the United States, as this will ensure greater protection of their investment, and frequently timelier payout of cash or transfer of securities. As a risk reduction strategy, it also makes sense for investors to diversify their investment holdings across several securities firms, reducing their risk of loss from firm failure.

V. **Conclusion**

At the heart of all the issues canvassed in this paper is the allocation of risk and the allocation of remedies at the point of firm insolvency. It is uncontested that in the ordinary course of business, equity claims come last in the hierarchy of claims. What is less clear is whether this should encompass all equity claims or whether claims arising from the violation of public statutes designed to protect equity investors ought to be treated differently. Discerning the optimal allocation of risk is a complex challenge if one is trying to maximize the simultaneous advancement of securities law and insolvency law public policy goals. The U.S., the U.K., and Australia have all used legislation to establish the subordination of equity claims to those of creditors, with Canada soon to follow suit.

The challenge is to advance the protection of investors as much as possible while recognizing the importance of the priority scheme of credit claims under insolvency legislation. The critical question is the nature of the claim advanced by the securities holder, and is it more properly characterized as a claim in equity arising out of ordinary business risk, or is it more akin to a claim of an unsecured creditor where the claim arises from a statutory violation under securities or corporate law. It would seem that absolute subordination of all shareholder claims is overreach by insolvency legislation that may give rise to inappropriate incentives for corporate officers within the insolvency law regime where restructuring is an option.

The U.S. has provided a limited statutory exception to complete subordination through the fair funds provisions of the *Sarbanes-Oxley Act.* Courts have permitted the SEC claims for penalties and disgorgement to rank equally with unsecured claims even though the funds are to be distributed to shareholders. The U.K. and now Australian schemes permit shareholders to claim directly as unsecured creditors for fraudulent acts and misrepresentation by the issuer. Canada alone of the countries discussed in this paper has not come to grips with the distinction between ordinary

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equity claims and those based on wrongdoing either legislatively or judicially. What are the options and policy grounds for adopting a particular approach?

Several policy options were canvassed in Part III. The first was that only new purchasers of securities would have claims arising from securities law violations ranked equally with unsecured creditors, on the basis that existing shareholders arguably have access to information such that they can be monitoring their risk; however, there may be problems with this approach based on public policy considerations discussed above. It is unclear that there has been a cogent public policy rationale advanced for the proposition that shareholders and creditors should be treated differently in respect of securities laws violations where neither contracted for fraud risk and frequently neither have the capacity to monitor against such risk. Another option is to grant securities regulators enhanced powers such that disgorgement of funds and penalties paid for misconduct can be directed towards investors harmed by the misconduct of the debtor corporation or its officers, as has occurred in the U.S. The positive aspects of this remedy, including the gatekeeping role of the SEC, need to be weighed realistically against whether a jurisdiction would commit the resources and energy to securities enforcement to make such remedies meaningful or effective. Another option would be to treat shareholder claims arising out of securities law violations as unsecured claims. Here too, there are a number of consequences that would have to be considered in order to design a framework that was expeditious and fair for the valuation and resolution of such claims.

These and other options need to be carefully developed as part of an ongoing public policy debate. It seems unclear why jurisdictions are moving on the one hand to enhance the remedies available to securities holders for corporate misconduct and on the other hand proposing that if the conduct is sufficiently egregious that satisfaction of claims makes the company insolvent, then the claims are completely subordinated to other interests in the firm. Most critically for the resolution of securities law claims within insolvency proceedings is whether there is a mechanism that can determine the validity and value of claims in an expeditious manner that would still allow equity claimants to participate in insolvency proceedings.

There are numerous other policy questions that continue to be underdeveloped and which are beyond the scope of this paper. One is to consider the changing nature of risk in equity investments. For example, pension funds are considered to be sophisticated investors that are able to monitor corporations for misconduct and hence should bear the full brunt of the risk/reward paradigm in corporate law in that they have bought equity understanding the risk associated with this form of investment. While this is true, the global move to defined contribution plans from defined benefit plans means that losses from corporate misconduct are borne more directly by employees and pensioners contributing to the funds. One reason to consider a different policy is that the people are not just investing their spare money in equity, but rather they are being used to fund pensions and retirements savings, so there is a bigger effect than individuals losing surplus money that they are investing in equity markets. Moreover, if there is fraud or misrepresentation that causes damage to the

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value of equity, it is not the risk that workers or their pension funds bought into any more than it is the risk that creditors bought into.

Another question that requires further scholarly attention is whether there are lessons for states with emerging capital markets and developing securities law regimes in respect of how to reconcile the exigencies of both insolvency legislation and securities legislation. How can pursuit of securities holders' claims be facilitated at the same time as creating mechanisms for timely resolution of such claims so that there can be an expeditious resolution to the insolvency? These and other questions deserve further study and public policy debate. While securities law and insolvency law regimes may not always sit comfortably with one another, they do need to be reconciled to achieve the simultaneous advancement of the public policy goals of each.

A further area that was not addressed in this paper and for which research is needed is the impact of electronic transfer of securities legislation, in particular, the challenges posed with multiple intermediaries, and the status of a security where a transfer is made just prior to insolvency proceedings. Transactions may be set aside on the basis that the transfer was made in a specified period leading up to insolvency, those periods varying considerably across jurisdictions. However, the risk of insolvency and consequent setting aside of transfers can be problematic in settlement systems as delivery is highly dependent on different securities transfer rules and different systems. A number of jurisdictions are enacting securities transfer legislation that begins to address these issues. Further research regarding the management of legal risks is required.

Numerous jurisdictions have not hesitated to adopt a codified response to the time and resources consumed in trying to deal with the various common law tracing claims by customers in a securities firm insolvency. Of course, an important difference is that the customers' claims originate as property claims whereas the fraud and misrepresentation claims of shareholders are not founded on property rights. However, there may be elements of such models that could be applied generally in fashioning a framework to deal with securities law claims in insolvency proceedings.

If the public policy goal of both securities law and insolvency law is to foster efficient and cost-effective capital markets, it seems that the systems need to be better reconciled than currently. From a securities law perspective, there must be confidence in meaningful remedies for capital markets violations if investors are to continue to invest. From an insolvency perspective, creditors make their pricing and credit availability choices based on certainty regarding their claims and shifting those priorities may affect the availability of credit. In this respect, however, it is important to note that recognizing claims arising from securities law violations would not affect the realization of claims by secured creditors, who would continue to rank in priority and who generally set the thresholds for pricing of credit. Further study and public policy debate about the intersection of these important areas of law is required.

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11

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

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.

12

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.

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 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 a pure question of law, which we review de novo. See id.

II.

A.

Section 510(b) of the Bankruptcy Code provides:

> 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] ("[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. 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]

13

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.

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. *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. 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"). *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 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]

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 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 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.

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.

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.

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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.

COUNSEL: Laurie Selber Silverstein, William A. Hazeltine, Potter Anderson & Corroon LLP and Neil B. Glassman, Scott D. Cousins, The Bayard Firm, Wilmington, DE, for Mid-American Waste Systems, Inc.

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Evan R. Chesler, Robert H. Baron, Daniel Slifkin, Marcus A. Asner, Cravath, Swaine & Moore, New York, NY, for Donaldson, Lufkin & Jenrette Securities Corporation.

Anne Bookout, Smith Katzenstein & Furlow LLP, Wilmington, DE, for Certain Officers [**2] & Directors.

Alan J. Lipkin, Jil Mazer-Marino, Willkie Farr & Gallagher, New York, NY, for Certain Officers & Directors.

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.

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)*.

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.

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 "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.

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 *§ 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.

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 *§ 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)*. 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 *§ 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:

> 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. *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.

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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.

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.

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 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)*.**

> ***[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: "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

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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

COUNSEL: P. Gruenberger, Esq., Weil, Gotshal & Manges, New York, New York, for The Drexel Burnham Lambert Group, Inc., et al. (Drexel).

E. Sherby, Fried, Frank, Harris, Schriver & Jacobson, New York, New York for the thirty seven claimants (the "Claimants").

G. Sanders, Dewey Ballantine, New York, New York for The First Boston Corporation (First Boston).

P. Armstrong, New York, New York for Kidder, Peabody & Co. Incorporated (Kidder).

D. Jaroslaw, Esq., Paul, Weiss, Rifkind, Wharton & Garrison for Advest, Inc. (Advest), and Shearson Lehman Brothers (Shearson Lehman).

S. Santoro, Esq., Christy & Viener, New York, New York for Prudential Securities Inc. (Prudential).

J. Benedict, Esq., Rogers & Wells, New York, New York for Merrill Lynch, Pierce, Fenner & Smith, Inc. (Merrill Lynch).

H. Goldstein, Fried, Frank, Harris, Shriver & Jacobson, New York, New York for Howard, Weil, Labouisse, Friedrichs Incorporated (Howard Weil).

L. Dummett, Esq., Cleary, Gottlieb, Steen & Hamilton, New York, New York for L.F. Rothschild (Rothschild).

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

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):
>
> 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. "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, 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 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

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.

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.

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 "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*. "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.

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. 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 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. 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, 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*. "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)* 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.

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. 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)*. 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:

> 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)*. 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:

> 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.

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

United States Bankruptcy Judge

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

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

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

Applicant

ONTARIO
SUPERIOR COURT OF JUSTICE
- COMMERCIAL LIST

Proceeding commenced at TORONTO

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