Court of Appeal File No. M41654
Superior Court File No. CV-12-9667-00-CL

# COURT OF APPEAL FOR ONTARIO

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

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

Applicant

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

# BOOK OF AUTHORITIES OF THE APPELLANT, ERNST & YOUNG LLP

October 26, 2012


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TO: **THE SERVICE LIST**

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7. Ruth Sullivan, *Sullivan on the Construction of Statutes* (Markham: LexisNexis Canada Inc., 2008).
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15. Report of the Standing Senate 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*" (2003).

16. Bill C-12, Clause by Clause Analysis, Clause Nos. 71 and 105.

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

18. Senate of Canada, Proceedings of the Standing Committee on Banking, Trade and Commerce, 39th Par 1., 2nd Sess, No. 2 (29 November 2007) at 2:26 (Colin Carnie).

19. Golick, Steven G. and Edward Sellers, "Corporate Governance" in Ben-Ishai, Stephanie and Duggan, Anthony (eds.), *Canadian Bankruptcy and Insolvency Law : Bill C-55, Statute C. 47 and Beyond*, Lexis Nexis, Toronto, 2007.

20. Richard H. McLaren, *Canadian Commercial Reorganization : Preventing Bankruptcy*, vol. 2, Thomson Reuters, Toronto, (Loose-leaf dated June 2012).

21. Lazar Sarna, *Law of Bankruptcy and Insolvency in Canada*, Lexis Nexis, Toronto, 2012, §7.3.a.ii.

# TAB 1

*Case Name:*

# ATB Financial v. Metcalfe & Mansfield Alternative Investments II Corp.

**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 and Arrangement involving Metcalfe & Mansfield Alternative Investments II Corp., Metcalfe & Mansfield Alternative Investments III Corp., Metcalfe & Mansfield Alternative Investments V Corp., Metcalfe & Mansfield Alternative Investments XI Corp., Metcalfe & Mansfield Alternative Investments XII Corp., 4446372 Canada Inc. and 6932819 Canada Inc., Trustees of the Conduits Listed In Schedule "A" Hereto**
**Between**
**The Investors represented on the Pan-Canadian Investors Committee for Third-Party Structured Asset-Backed Commercial Paper listed in Schedule "B" hereto, Applicants (Respondents in Appeal), and Metcalfe & Mansfield Alternative Investments II Corp., Metcalfe & Mansfield Alternative Investments III Corp., Metcalfe & Mansfield Alternative Investments V Corp., Metcalfe & Mansfield Alternative Investments XI Corp., Metcalfe & Mansfield Alternative Investments XII Corp., 6932819 Canada Inc. and 4446372 Canada Inc., Trustees of the Conduits listed in Schedule "A" hereto, Respondents (Respondents in Appeal), and Air Transat A.T. Inc., Transat Tours Canada Inc., The Jean Coutu Group (PJC) Inc., Aéroports de Montréal Inc., Aéroports de Montréal Capital Inc., Pomerleau Ontario Inc., Pomerleau Inc., Labopharm Inc., Domtar Inc., Domtar Pulp and Paper Products Inc., GIRO Inc., Vêtements de sports R.G.R. Inc., 131519 Canada Inc., Air Jazz LP, Petrifond Foundation Company Limited, Petrifond Foundation Midwest Limited, Services hypothécaires la patrimoniale Inc., TECSYS Inc., Société générale de financement du Québec, VibroSystM Inc., Interquisa Canada L.P., Redcorp Ventures Ltd., Jura Energy Corporation, Ivanhoe Mines Ltd., WebTech Wireless Inc., Wynn Capital Corporation Inc., Hy Bloom Inc., Cardacian Mortgage Services, Inc., West Energy Ltd., Sabre Enerty Ltd., Petrolifera Petroleum Ltd., Vaquero Resources Ltd. and Standard Energy Inc., Respondents (Appellants)**

[2008] O.J. No. 3164

2008 ONCA 587

45 C.B.R. (5th) 163

296 D.L.R. (4th) 135

2008 CarswellOnt 4811

168 A.C.W.S. (3d) 698

240 O.A.C. 245

47 B.L.R. (4th) 123

92 O.R. (3d) 513

Docket: C48969 (M36489)

Ontario Court of Appeal
Toronto, Ontario

**J.I. Laskin, E.A. Cronk and R.A. Blair JJ.A.**

Heard: June 25-26, 2008.
Judgment: August 18, 2008.

(121 paras.)

*Bankruptcy and insolvency law -- Proceedings in bankruptcy and insolvency -- Practice and procedure -- General principles -- Legislation -- Interpretation -- Courts -- Jurisdiction -- Federal -- Companies' Creditors Arrangement Act -- Application by certain creditors opposed to a Plan of Compromise and Arrangement for leave to appeal sanctioning of that Plan -- Pan-Canadian Investors Committee was formed and ultimately put forward the creditor-initiated Plan of Compromise and Arrangement that formed the subject matter of the proceedings -- Plan dealt with liquidity crisis threatening Canadian market in Asset Backed Commercial Paper -- Plan was sanctioned by court -- Leave to appeal allowed and appeal dismissed -- CCAA permitted the inclusion of third party releases in a plan of compromise or arrangement to be sanctioned by the court -- Companies' Creditors Arrangement Act, ss. 4, 6.*

Application by certain creditors opposed to a Plan of Compromise and Arrangement for leave to appeal the sanctioning of that Plan. In August 2007, a liquidity crisis threatened the Canadian market in Asset Backed Commercial Paper (ABCP). The crisis was triggered by a loss of confidence amongst investors stemming from the news of widespread defaults on US sub-prime mortgages. By agreement amongst the major Canadian participants, the $32 billion Canadian market in third-party ABCP was frozen on August 13, 2007, pending an attempt to resolve the crisis through a restructuring of that market. The Pan-Canadian Investors Committee was formed and ultimately put forward the creditor-initiated Plan of Compromise and Arrangement that formed the subject matter of the proceedings. The Plan was sanctioned on June 5, 2008. The applicants raised an important point regarding the permissible scope of restructuring under the Companies' Creditors Arrangement Act: could the court sanction a Plan that called for creditors to provide releases to third parties who were themselves insolvent and not creditors

of the debtor company? They also argued that if the answer to that question was yes, the application judge erred in holding that the Plan, with its particular releases (which barred some claims even in fraud), was fair and reasonable and therefore in sanctioning it under the CCAA.

HELD: Application for leave to appeal allowed and appeal dismissed. The appeal raised issues of considerable importance to restructuring proceedings under the CCAA Canada-wide. There were serious and arguable grounds of appeal and the appeal would not unduly delay the progress of the proceedings. In the circumstances, the criteria for granting leave to appeal were met. Respecting the appeal, the CCAA permitted the inclusion of third party releases in a plan of compromise or arrangement to be sanctioned by the court where the releases were reasonably connected to the proposed restructuring. The wording of the CCAA, construed in light of the purpose, objects and scheme of the Act, supported the court's jurisdiction and authority to sanction the Plan proposed in this case, including the contested third-party releases contained in it. The Plan was fair and reasonable in all the circumstances.

**Statutes, Regulations and Rules Cited:**

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

Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, s. 4, s. 6

Constitution Act, 1867, R.S.C. 1985, App. II, No. 5, s. 91(21), s. 92(13)

**Appeal From:**

On appeal from the sanction order of Justice Colin L. Campbell of the Superior Court of Justice, dated June 5, 2008, with reasons reported at [2008] O.J. No. 2265.

**Counsel:**

See Schedule "A" for the list of counsel.

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The judgment of the Court was delivered by

**R.A. BLAIR J.A.**:--

**A. INTRODUCTION**

**1** In August 2007 a liquidity crisis suddenly threatened the Canadian market in Asset Backed Commercial Paper ("ABCP"). The crisis was triggered by a loss of confidence amongst investors stemming from the news of widespread defaults on U.S. sub-prime mortgages. The loss of confidence placed the Canadian financial market at risk generally and was reflective of an economic volatility worldwide.

**2** By agreement amongst the major Canadian participants, the $32 billion Canadian market in third-party ABCP was frozen on August 13, 2007 pending an attempt to resolve the crisis through a restructuring of that market. The Pan-Canadian Investors Committee, chaired by Purdy Crawford, C.C., Q.C., was formed and ultimately put forward the creditor-initiated Plan of Compromise and Arrangement that forms the subject-matter of these proceedings. The Plan was sanctioned by Colin L. Campbell J. on June 5, 2008.

**3** Certain creditors who opposed the Plan seek leave to appeal and, if leave is granted, appeal from that decision. They raise an important point regarding the permissible scope of a restructuring under the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36 as amended ("CCAA"): can the court sanction a Plan that calls for creditors to provide releases to third parties who are themselves solvent and not creditors of the debtor company? They also argue that, if the answer to this question is yes, the application judge erred in holding that this Plan, with its particular releases (which bar some claims even in fraud), was fair and reasonable and therefore in sanctioning it under the CCAA.

Leave to Appeal

**4** Because of the particular circumstances and urgency of these proceedings, the court agreed to collapse an oral hearing for leave to appeal with the hearing of the appeal itself. At the outset of argument we encouraged counsel to combine their submissions on both matters.

**5** The proposed appeal raises issues of considerable importance to restructuring proceedings under the CCAA Canada-wide. There are serious and arguable grounds of appeal and -- given the expedited time-table -- the appeal will not unduly delay the progress of the proceedings. I am satisfied that the criteria for granting leave to appeal in CCAA proceedings, set out in such cases as *Re Cineplex Odeon Corp.* (2001), 24 C.B.R. (4th) 21 (Ont. C.A.), and *Re Country Style Food Services* (2002), 158 O.A.C. 30, are met. I would grant leave to appeal.

Appeal

**6** For the reasons that follow, however, I would dismiss the appeal.

## B. FACTS

### The Parties

**7** The appellants are holders of ABCP Notes who oppose the Plan. They do so principally on the basis that it requires them to grant releases to third party financial institutions against whom they say they have claims for relief arising out of their purchase of ABCP Notes. Amongst them are an airline, a tour operator, a mining company, a wireless provider, a pharmaceuticals retailer, and several holding companies and energy companies.

**8** Each of the appellants has large sums invested in ABCP -- in some cases, hundreds of millions of dollars. Nonetheless, the collective holdings of the appellants -- slightly over $1 billion -- represent only a small fraction of the more than $32 billion of ABCP involved in the restructuring.

**9** The lead respondent is the Pan-Canadian Investors Committee which was responsible for the creation and negotiation of the Plan on behalf of the creditors. Other respondents include various major international financial institutions, the five largest Canadian banks, several trust companies, and some smaller holders of ABCP product. They participated in the market in a number of different ways.

### The ABCP Market

**10** Asset Backed Commercial Paper is a sophisticated and hitherto well-accepted financial instrument. It is primarily a form of short-term investment -- usually 30 to 90 days -- typically with a low interest yield only slightly better than that available through other short-term paper from a government or bank. It is said to be "asset backed" because the cash that is used to purchase an ABCP Note is converted into a portfolio of financial assets or other asset interests that in turn provide security for the repayment of

the notes.

11 ABCP was often presented by those selling it as a safe investment, somewhat like a guaranteed investment certificate.

12 The Canadian market for ABCP is significant and administratively complex. As of August 2007, investors had placed over $116 billion in Canadian ABCP. Investors range from individual pensioners to large institutional bodies. On the selling and distribution end, numerous players are involved, including chartered banks, investment houses and other financial institutions. Some of these players participated in multiple ways. The Plan in this proceeding relates to approximately $32 billion of non-bank sponsored ABCP the restructuring of which is considered essential to the preservation of the Canadian ABCP market.

13 As I understand it, prior to August 2007 when it was frozen, the ABCP market worked as follows.

14 Various corporations (the "Sponsors") would arrange for entities they control ("Conduits") to make ABCP Notes available to be sold to investors through "Dealers" (banks and other investment dealers). Typically, ABCP was issued by series and sometimes by classes within a series.

15 The cash from the purchase of the ABCP Notes was used to purchase assets which were held by trustees of the Conduits ("Issuer Trustees") and which stood as security for repayment of the notes. Financial institutions that sold or provided the Conduits with the assets that secured the ABCP are known as "Asset Providers". To help ensure that investors would be able to redeem their notes, "Liquidity Providers" agreed to provide funds that could be drawn upon to meet the demands of maturing ABCP Notes in certain circumstances. Most Asset Providers were also Liquidity Providers. Many of these banks and financial institutions were also holders of ABCP Notes ("Noteholders"). The Asset and Liquidity Providers held first charges on the assets.

16 When the market was working well, cash from the purchase of new ABCP Notes was also used to pay off maturing ABCP Notes; alternatively, Noteholders simply rolled their maturing notes over into new ones. As I will explain, however, there was a potential underlying predicament with this scheme.

**The Liquidity Crisis**

17 The types of assets and asset interests acquired to "back" the ABCP Notes are varied and complex. They were generally long-term assets such as residential mortgages, credit card receivables, auto loans, cash collateralized debt obligations and derivative investments such as credit default swaps. Their particular characteristics do not matter for the purpose of this appeal, but they shared a common feature that proved to be the Achilles heel of the ABCP market: because of their long-term nature there was an inherent timing mismatch between the cash they generated and the cash needed to repay maturing ABCP Notes.

18 When uncertainty began to spread through the ABCP marketplace in the summer of 2007, investors stopped buying the ABCP product and existing Noteholders ceased to roll over their maturing notes. There was no cash to redeem those notes. Although calls were made on the Liquidity Providers for payment, most of the Liquidity Providers declined to fund the redemption of the notes, arguing that the conditions for liquidity funding had not been met in the circumstances. Hence the "liquidity crisis" in the ABCP market.

19 The crisis was fuelled largely by a lack of transparency in the ABCP scheme. Investors could not tell what assets were backing their notes -- partly because the ABCP Notes were often sold before or at the same time as the assets backing them were acquired; partly because of the sheer complexity of

certain of the underlying assets; and partly because of assertions of confidentiality by those involved with the assets. As fears arising from the spreading U.S. sub-prime mortgage crisis mushroomed, investors became increasingly concerned that their ABCP Notes may be supported by those crumbling assets. For the reasons outlined above, however, they were unable to redeem their maturing ABCP Notes.

The Montreal Protocol

**20** The liquidity crisis could have triggered a wholesale liquidation of the assets, at depressed prices. But it did not. During the week of August 13, 2007, the ABCP market in Canada froze -- the result of a standstill arrangement orchestrated on the heels of the crisis by numerous market participants, including Asset Providers, Liquidity Providers, Noteholders and other financial industry representatives. Under the standstill agreement -- known as the Montréal Protocol -- the parties committed to restructuring the ABCP market with a view, as much as possible, to preserving the value of the assets and of the notes.

**21** The work of implementing the restructuring fell to the Pan-Canadian Investors Committee, an applicant in the proceeding and respondent in the appeal. The Committee is composed of 17 financial and investment institutions, including chartered banks, credit unions, a pension board, a Crown corporation, and a university board of governors. All 17 members are themselves Noteholders; three of them also participated in the ABCP market in other capacities as well. Between them, they hold about two thirds of the $32 billion of ABCP sought to be restructured in these proceedings.

**22** Mr. Crawford was named the Committee's chair. He thus had a unique vantage point on the work of the Committee and the restructuring process as a whole. His lengthy affidavit strongly informed the application judge's understanding of the factual context, and our own. He was not cross-examined and his evidence is unchallenged.

**23** Beginning in September 2007, the Committee worked to craft a plan that would preserve the value of the notes and assets, satisfy the various stakeholders to the extent possible, and restore confidence in an important segment of the Canadian financial marketplace. In March 2008, it and the other applicants sought CCAA protection for the ABCP debtors and the approval of a Plan that had been pre-negotiated with some, but not all, of those affected by the misfortunes in the Canadian ABCP market.

**The Plan**

a) Plan Overview

**24** Although the ABCP market involves many different players and kinds of assets, each with their own challenges, the committee opted for a single plan. In Mr. Crawford's words, "all of the ABCP suffers from common problems that are best addressed by a common solution." The Plan the Committee developed is highly complex and involves many parties. In its essence, the Plan would convert the Noteholders' paper -- which has been frozen and therefore effectively worthless for many months -- into new, long-term notes that would trade freely, but with a discounted face value. The hope is that a strong secondary market for the notes will emerge in the long run.

**25** The Plan aims to improve transparency by providing investors with detailed information about the assets supporting their ABCP Notes. It also addresses the timing mismatch between the notes and the assets by adjusting the maturity provisions and interest rates on the new notes. Further, the Plan adjusts some of the underlying credit default swap contracts by increasing the thresholds for default triggering events; in this way, the likelihood of a forced liquidation flowing from the credit default swap holder's prior security is reduced and, in turn, the risk for ABCP investors is decreased.

26 Under the Plan, the vast majority of the assets underlying ABCP would be pooled into two master asset vehicles (MAV1 and MAV2). The pooling is designed to increase the collateral available and thus make the notes more secure.

27 The Plan does not apply to investors holding less than $1 million of notes. However, certain Dealers have agreed to buy the ABCP of those of their customers holding less than the $1-million threshold, and to extend financial assistance to these customers. Principal among these Dealers are National Bank and Canaccord, two of the respondent financial institutions the appellants most object to releasing. The application judge found that these developments appeared to be designed to secure votes in favour of the Plan by various Noteholders, and were apparently successful in doing so. If the Plan is approved, they also provide considerable relief to the many small investors who find themselves unwittingly caught in the ABCP collapse.

b) The Releases

28 This appeal focuses on one specific aspect of the Plan: the comprehensive series of releases of third parties provided for in Article 10.

29 The Plan calls for the release of Canadian banks, Dealers, Noteholders, Asset Providers, Issuer Trustees, Liquidity Providers, and other market participants -- in Mr. Crawford's words, "virtually all participants in the Canadian ABCP market" -- from any liability associated with ABCP, with the exception of certain narrow claims relating to fraud. For instance, under the Plan as approved, creditors will have to give up their claims against the Dealers who sold them their ABCP Notes, including challenges to the way the Dealers characterized the ABCP and provided (or did not provide) information about the ABCP. The claims against the proposed defendants are mainly in tort: negligence, misrepresentation, negligent misrepresentation, failure to act prudently as a dealer/advisor, acting in conflict of interest, and in a few cases fraud or potential fraud. There are also allegations of breach of fiduciary duty and claims for other equitable relief.

30 The application judge found that, in general, the claims for damages include the face value of the Notes, plus interest and additional penalties and damages.

31 The releases, in effect, are part of a *quid pro quo*. Generally speaking, they are designed to compensate various participants in the market for the contributions they would make to the restructuring. Those contributions under the Plan include the requirements that:

a) Asset Providers assume an increased risk in their credit default swap contracts, disclose certain proprietary information in relation to the assets, and provide below-cost financing for margin funding facilities that are designed to make the notes more secure;
b) Sponsors -- who in addition have cooperated with the Investors' Committee throughout the process, including by sharing certain proprietary information -- give up their existing contracts;
c) The Canadian banks provide below-cost financing for the margin funding facility and,
d) Other parties make other contributions under the Plan.

32 According to Mr. Crawford's affidavit, the releases are part of the Plan "because certain key participants, whose participation is vital to the restructuring, have made comprehensive releases a condition for their participation."

### The CCAA Proceedings to Date

**33** On March 17, 2008 the applicants sought and obtained an Initial Order under the CCAA staying any proceedings relating to the ABCP crisis and providing for a meeting of the Noteholders to vote on the proposed Plan. The meeting was held on April 25th. The vote was overwhelmingly in support of the Plan -- 96% of the Noteholders voted in favour. At the instance of certain Noteholders, and as requested by the application judge (who has supervised the proceedings from the outset), the Monitor broke down the voting results according to those Noteholders who had worked on or with the Investors' Committee to develop the Plan and those Noteholders who had not. Re-calculated on this basis the results remained firmly in favour of the proposed Plan -- 99% of those connected with the development of the Plan voted positively, as did 80% of those Noteholders who had not been involved in its formulation.

**34** The vote thus provided the Plan with the "double majority" approval -- a majority of creditors representing two-thirds in value of the claims -- required under s. 6 of the CCAA.

**35** Following the successful vote, the applicants sought court approval of the Plan under s. 6. Hearings were held on May 12 and 13. On May 16, the application judge issued a brief endorsement in which he concluded that he did not have sufficient facts to decide whether all the releases proposed in the Plan were authorized by the CCAA. While the application judge was prepared to approve the releases of negligence claims, he was not prepared at that point to sanction the release of fraud claims. Noting the urgency of the situation and the serious consequences that would result from the Plan's failure, the application judge nevertheless directed the parties back to the bargaining table to try to work out a claims process for addressing legitimate claims of fraud.

**36** The result of this renegotiation was a "fraud carve-out" -- an amendment to the Plan excluding certain fraud claims from the Plan's releases. The carve-out did not encompass all possible claims of fraud, however. It was limited in three key respects. First, it applied only to claims against ABCP Dealers. Secondly, it applied only to cases involving an express fraudulent misrepresentation made with the intention to induce purchase and in circumstances where the person making the representation knew it to be false. Thirdly, the carve-out limited available damages to the value of the notes, minus any funds distributed as part of the Plan. The appellants argue vigorously that such a limited release respecting fraud claims is unacceptable and should not have been sanctioned by the application judge.

**37** A second sanction hearing -- this time involving the amended Plan (with the fraud carve-out) -- was held on June 3, 2008. Two days later, Campbell J. released his reasons for decision, approving and sanctioning the Plan on the basis both that he had jurisdiction to sanction a Plan calling for third-party releases and that the Plan including the third-party releases in question here was fair and reasonable.

**38** The appellants attack both of these determinations.

## C. LAW AND ANALYSIS

**39** There are two principal questions for determination on this appeal:

1) As a matter of law, may a CCAA plan contain a release of claims against anyone other than the debtor company or its directors?
2) If the answer to that question is yes, did the application judge err in the exercise of his discretion to sanction the Plan as fair and reasonable given the nature of the releases called for under it?

### (1) Legal Authority for the Releases

**40** The standard of review on this first issue -- whether, as a matter of law, a CCAA plan may contain third-party releases -- is correctness.

**41** The appellants submit that a court has no jurisdiction or legal authority under the CCAA to sanction a plan that imposes an obligation on creditors to give releases to third parties other than the directors of the debtor company.[1] The requirement that objecting creditors release claims against third parties is illegal, they contend, because:

a) on a proper interpretation, the CCAA does not permit such releases;
b) the court is not entitled to "fill in the gaps" in the CCAA or rely upon its inherent jurisdiction to create such authority because to do so would be contrary to the principle that Parliament did not intend to interfere with private property rights or rights of action in the absence of clear statutory language to that effect;
c) the releases constitute an unconstitutional confiscation of private property that is within the exclusive domain of the provinces under s. 92 of the *Constitution Act*, 1867;
d) the releases are invalid under Quebec rules of public order; and because
e) the prevailing jurisprudence supports these conclusions.

**42** I would not give effect to any of these submissions.

Interpretation, "Gap Filling" and Inherent Jurisdiction

**43** On a proper interpretation, in my view, the CCAA permits the inclusion of third party releases in a plan of compromise or arrangement to be sanctioned by the court where those releases are reasonably connected to the proposed restructuring. I am led to this conclusion by a combination of (a) the open-ended, flexible character of the CCAA itself, (b) the broad nature of the term "compromise or arrangement" as used in the Act, and (c) the express statutory effect of the "double-majority" vote and court sanction which render the plan binding on all creditors, including those unwilling to accept certain portions of it. The first of these signals a flexible approach to the application of the Act in new and evolving situations, an active judicial role in its application and interpretation, and a liberal approach to that interpretation. The second provides the entrée to negotiations between the parties affected in the restructuring and furnishes them with the ability to apply the broad scope of their ingenuity in fashioning the proposal. The latter afford necessary protection to unwilling creditors who may be deprived of certain of their civil and property rights as a result of the process.

**44** The CCAA is skeletal in nature. It does not contain a comprehensive code that lays out all that is permitted or barred. Judges must therefore play a role in fleshing out the details of the statutory scheme. The scope of the Act and the powers of the court under it are not limitless. It is beyond controversy, however, that the CCAA is remedial legislation to be liberally construed in accordance with the modern purposive approach to statutory interpretation. It is designed to be a flexible instrument and it is that very flexibility which gives the Act its efficacy: *Canadian Red Cross Society (Re)* (1998), 5 C.B.R. (4th) 299 (Ont. Gen. Div.). As Farley J. noted in *Re Dylex Ltd.* (1995), 31 C.B.R. (3d) 106 at 111 (Ont. Gen. Div.), "[t]he history of CCAA law has been an evolution of judicial interpretation."

**45** Much has been said, however, about the "evolution of judicial interpretation" and there is some controversy over both the source and scope of that authority. Is the source of the court's authority statutory, discerned solely through application of the principles of statutory interpretation, for example? Or does it rest in the court's ability to "fill in the gaps" in legislation? Or in the court's inherent

jurisdiction?

**46** These issues have recently been canvassed by the Honourable Georgina R. Jackson and Dr. Janis Sarra in their publication "Selecting the Judicial Tool to get the Job Done: An Examination of Statutory Interpretation, Discretionary Power and Inherent Jurisdiction in Insolvency Matters,"[2] and there was considerable argument on these issues before the application judge and before us. While I generally agree with the authors' suggestion that the courts should adopt a hierarchical approach in their resort to these interpretive tools -- statutory interpretation, gap-filling, discretion and inherent jurisdiction -- it is not necessary in my view to go beyond the general principles of statutory interpretation to resolve the issues on this appeal. Because I am satisfied that it is implicit in the language of the CCAA itself that the court has authority to sanction plans incorporating third-party releases that are reasonably related to the proposed restructuring, there is no "gap-filling" to be done and no need to fall back on inherent jurisdiction. In this respect, I take a somewhat different approach than the application judge did.

**47** The Supreme Court of Canada has affirmed generally -- and in the insolvency context particularly -- that remedial statutes are to be interpreted liberally and in accordance with Professor Driedger's modern principle of statutory interpretation. Driedger advocated that "the words of an Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament": *Re Rizzo & Rizzo Shoes Ltd.*, [1998] 1 S.C.R. 27 at para. 21, quoting E.A. Driedger, *Construction of Statutes*, 2nd ed. (Toronto: Butterworths, 1983); *Bell Expressvu Ltd. Partnership v. R.*, [2002] 2 S.C.R. 559 at para. 26.

**48** More broadly, I believe that the proper approach to the judicial interpretation and application of statutes -- particularly those like the CCAA that are skeletal in nature -- is succinctly and accurately summarized by Jackson and Sarra in their recent article, *supra*, at p. 56:

> The exercise of a statutory authority requires the statute to be construed. The plain meaning or textualist approach has given way to a search for the object and goals of the statute and the intentionalist approach. This latter approach makes use of the purposive approach and the mischief rule, including its codification under interpretation statutes that every enactment is deemed remedial, and is to be given such fair, large and liberal construction and interpretation as best ensures the attainment of its objects. This latter approach advocates reading the statute as a whole and being mindful of Driedger's "one principle", that the words of the Act are to be read in their entire context, in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament. It is important that courts first interpret the statute before them and exercise their authority pursuant to the statute, before reaching for other tools in the judicial toolbox. Statutory interpretation using the principles articulated above leaves room for gap-filling in the common law provinces and a consideration of purpose in *Québec* as a manifestation of the judge's overall task of statutory interpretation. Finally, the jurisprudence in relation to statutory interpretation demonstrates the fluidity inherent in the judge's task in seeking the objects of the statute and the intention of the legislature.

**49** I adopt these principles.

**50** The remedial purpose of the CCAA -- as its title affirms -- is to facilitate compromises or arrangements between an insolvent debtor company and its creditors. In *Chef Ready Foods Ltd. v. Hongkong Bank of Canada* (1990), 4 C.B.R. (3d) 311 at 318 (B.C.C.A.), Gibbs J.A. summarized very concisely the purpose, object and scheme of the Act:

> Almost inevitably, liquidation destroyed the shareholders' investment, yielded little by way of recovery to the creditors, and exacerbated the social evil of devastating levels of unemployment. The government of the day sought, through the C.C.A.A., to create a regime whereby the principals of the company and the creditors could be brought together under the supervision of the court to attempt a reorganization or compromise or arrangement under which the company could continue in business.

**51** The CCAA was enacted in 1933 and was necessary -- as the then Secretary of State noted in introducing the Bill on First Reading -- "because of the prevailing commercial and industrial depression" and the need to alleviate the effects of business bankruptcies in that context: see the statement of the Hon. C.H. Cahan, Secretary of State, *House of Commons Debates (Hansard)* (April 20, 1933) at 4091. One of the greatest effects of that Depression was what Gibbs J.A. described as "the social evil of devastating levels of unemployment". Since then, courts have recognized that the Act has a broader dimension than simply the direct relations between the debtor company and its creditors and that this broader public dimension must be weighed in the balance together with the interests of those most directly affected: see, for example, *Elan Corp. v. Comiskey (Trustee of)* (1990), 1 O.R. (3d) 289 (C.A.), *per* Doherty J.A. in dissent; *Re Skydome Corp.* (1998), 16 C.B.R. (4th) 125 (Ont. Gen. Div.); *Re Anvil Range Mining Corp.* (1998), 3 C.B.R. (4th) 93 (Ont. Gen. Div.).

**52** In this respect, I agree with the following statement of Doherty J.A. in *Elan, supra,* at pp. 306-307:

> ... [T]he Act was designed to serve a "broad constituency of investors, creditors and employees".[3] Because of that "broad constituency" the court must, when considering applications brought under the Act, *have regard not only to the individuals and organizations directly affected by the application, but also to the wider public interest.* [Emphasis added.]

Application of the Principles of Interpretation

**53** An interpretation of the CCAA that recognizes its broader socio-economic purposes and objects is apt in this case. As the application judge pointed out, the restructuring underpins the financial viability of the Canadian ABCP market itself.

**54** The appellants argue that the application judge erred in taking this approach and in treating the Plan and the proceedings as an attempt to restructure a financial market (the ABCP market) rather than simply the affairs between the debtor corporations who caused the ABCP Notes to be issued and their creditors. The Act is designed, they say, only to effect reorganizations between a corporate debtor and its creditors and not to attempt to restructure entire marketplaces.

**55** This perspective is flawed in at least two respects, however, in my opinion. First, it reflects a view of the purpose and objects of the CCAA that is too narrow. Secondly, it overlooks the reality of the ABCP marketplace and the context of the restructuring in question here. It may be true that, in their capacity as ABCP *Dealers*, the releasee financial institutions are "third-parties" to the restructuring in the sense that they are not creditors of the debtor corporations. However, in their capacities as *Asset Providers* and *Liquidity Providers*, they are not only creditors but they are prior secured creditors to the Noteholders. Furthermore -- as the application judge found -- in these latter capacities they are making significant contributions to the restructuring by "foregoing immediate rights to assets and ... providing real and tangible input for the preservation and enhancement of the Notes" (para. 76). In this context, therefore, the application judge's remark at para. 50 that the restructuring "involves the commitment and participation of all parties" in the ABCP market makes sense, as do his earlier comments at paras. 48-49:

> Given the nature of the ABCP market and all of its participants, it is more appropriate to consider all Noteholders as claimants and the object of the Plan to restore liquidity to the assets being the Notes themselves. The restoration of the liquidity of the market necessitates the participation (including more tangible contribution by many) of all Noteholders.
>
> In these circumstances, *it is unduly technical to classify the Issuer Trustees as debtors and the claims of the Noteholders as between themselves and others as being those of third party creditors*, although I recognize that the restructuring structure of the CCAA requires the corporations as the vehicles for restructuring. [Emphasis added.]

**56** The application judge did observe that "[t]he insolvency is of the ABCP market itself, the restructuring is that of the market for such paper ..." (para. 50). He did so, however, to point out the uniqueness of the Plan before him and its industry-wide significance and not to suggest that he need have no regard to the provisions of the CCAA permitting a restructuring as between debtor and creditors. His focus was on *the effect* of the restructuring, a perfectly permissible perspective, given the broad purpose and objects of the Act. This is apparent from his later references. For example, in balancing the arguments against approving releases that might include aspects of fraud, he responded that "what is at issue is a liquidity crisis that affects the ABCP market in Canada" (para. 125). In addition, in his reasoning on the fair-and-reasonable issue, he stated at para. 142: "Apart from the Plan itself, there is a need to restore confidence in the financial system in Canada and this Plan is a legitimate use of the CCAA to accomplish that goal."

**57** I agree. I see no error on the part of the application judge in approaching the fairness assessment or the interpretation issue with these considerations in mind. They provide the context in which the purpose, objects and scheme of the CCAA are to be considered.

*The Statutory Wording*

**58** Keeping in mind the interpretive principles outlined above, I turn now to a consideration of the provisions of the CCAA. Where in the words of the statute is the court clothed with authority to approve a plan incorporating a requirement for third-party releases? As summarized earlier, the answer to that question, in my view, is to be found in:

> a) the skeletal nature of the CCAA;
> b) Parliament's reliance upon the broad notions of "compromise" and "arrangement" to establish the framework within which the parties may work to put forward a restructuring plan; and in
> c) the creation of the statutory mechanism binding all creditors in classes to the compromise or arrangement once it has surpassed the high "double majority" voting threshold and obtained court sanction as "fair and reasonable".

Therein lies the expression of Parliament's intention to permit the parties to negotiate and vote on, and the court to sanction, third-party releases relating to a restructuring.

**59** Sections 4 and 6 of the CCAA state:

> 4. Where a compromise or an arrangement is proposed between a debtor company and its unsecured creditors or any class of them, the court may, on the application in a summary way of the company, of any such creditor or of the trustee in bankruptcy or

liquidator of the company, order a meeting of the creditors or class of creditors, and, if the court so determines, of the shareholders of the company, to be summoned in such manner as the court directs.

6. Where a majority in number representing two-thirds in value of the creditors, or class of creditors, as the case may be, present and voting either in person or by proxy at the meeting or meetings thereof respectively held pursuant to sections 4 and 5, or either of those sections, agree to any compromise or arrangement either as proposed or as altered or modified at the meeting or meetings, the compromise or arrangement may be sanctioned by the court, and if so sanctioned is binding

(*a*) on all the creditors or the class of creditors, as the case may be, and on any trustee for any such class of creditors, whether secured or unsecured, as the case may be, and on the company; and

(*b*) in the case of a company that has made an authorized assignment or against which a bankruptcy order has been made under the *Bankruptcy and Insolvency Act* or is in the course of being wound up under the *Winding-up and Restructuring Act*, on the trustee in bankruptcy or liquidator and contributories of the company.

*Compromise or Arrangement*

**60** While there may be little practical distinction between "compromise" and "arrangement" in many respects, the two are not necessarily the same. "Arrangement" is broader than "compromise" and would appear to include any scheme for reorganizing the affairs of the debtor: Houlden and Morawetz, *Bankruptcy and Insolvency Law of Canada*, loose-leaf, 3rd ed., vol. 4 (Toronto: Thomson Carswell) at 10A-12.2, N para. 10. It has been said to be "a very wide and indefinite [word]": *Re Refund of Dues under Timber Regulations*, [1935] A.C. 184 at 197 (P.C.), affirming S.C.C. [1933] S.C.R. 616. See also, *Re Guardian Assur. Co.*, [1917] 1 Ch. 431 at 448, 450; *Re T&N Ltd. and Others (No. 3)*, [2007] 1 All E.R. 851 (Ch.).

**61** The CCAA is a sketch, an outline, a supporting framework for the resolution of corporate insolvencies in the public interest. Parliament wisely avoided attempting to anticipate the myriad of business deals that could evolve from the fertile and creative minds of negotiators restructuring their financial affairs. It left the shape and details of those deals to be worked out within the framework of the comprehensive and flexible concepts of a "compromise" and "arrangement." I see no reason why a release in favour of a third party, negotiated as part of a package between a debtor and creditor and reasonably relating to the proposed restructuring cannot fall within that framework.

**62** A proposal under the *Bankruptcy and Insolvency Act*, R.S., 1985, c. B-3 (the "BIA") is a contract: *Employers' Liability Assurance Corp. Ltd. v. Ideal Petroleum* (1959) Ltd. [1978] 1 S.C.R. 230 at 239; *Society of Composers, Authors & Music Publishers of Canada v. Armitage* (2000), 50 O.R. (3d) 688 at para. 11 (C.A.). In my view, a compromise or arrangement under the CCAA is directly analogous to a proposal for these purposes, and therefore is to be treated as a contract between the debtor and its creditors. Consequently, parties are entitled to put anything into such a plan that could lawfully be incorporated into any contract. See *Re Air Canada* (2004), 2 C.B.R. (5th) 4 at para. 6 (Ont. S.C.J.); *Olympia & York Developments Ltd. v. Royal Trust Co.* (1993), 12 O.R. (3d) 500 at 518 (Gen. Div.).

**63** There is nothing to prevent a debtor and a creditor from including in a contract between them a term providing that the creditor release a third party. The term is binding as between the debtor and creditor. In the CCAA context, therefore, a plan of compromise or arrangement may propose that creditors agree to compromise claims against the debtor and to release third parties, just as any debtor

and creditor might agree to such a term in a contract between them. Once the statutory mechanism regarding voter approval and court sanctioning has been complied with, the plan -- including the provision for releases -- becomes binding on all creditors (including the dissenting minority).

**64** *Re T&N Ltd. and Others, supra,* is instructive in this regard. It is a rare example of a court focussing on and examining the meaning and breadth of the term "arrangement". T&N and its associated companies were engaged in the manufacture, distribution and sale of asbestos-containing products. They became the subject of many claims by former employees, who had been exposed to asbestos dust in the course of their employment, and their dependents. The T&N companies applied for protection under s. 425 of the U.K. *Companies Act 1985*, a provision virtually identical to the scheme of the CCAA -- including the concepts of compromise or arrangement.[4]

**65** T&N carried employers' liability insurance. However, the employers' liability insurers (the "EL insurers") denied coverage. This issue was litigated and ultimately resolved through the establishment of a multi-million pound fund against which the employees and their dependants (the "EL claimants") would assert their claims. In return, T&N's former employees and dependants (the "EL claimants") agreed to forego any further claims against the EL insurers. This settlement was incorporated into the plan of compromise and arrangement between the T&N companies and the EL claimants that was voted on and put forward for court sanction.

**66** Certain creditors argued that the court could not sanction the plan because it did not constitute a "compromise or arrangement" between T&N and the EL claimants since it did not purport to affect rights as between them but only the EL claimants' rights against the EL insurers. The Court rejected this argument. Richards J. adopted previous jurisprudence -- cited earlier in these reasons -- to the effect that the word "arrangement" has a very broad meaning and that, while both a compromise and an arrangement involve some "give and take", an arrangement need not involve a compromise or be confined to a case of dispute or difficulty (paras. 46-51). He referred to what would be the equivalent of a solvent arrangement under Canadian corporate legislation as an example.[5] Finally, he pointed out that the compromised rights of the EL claimants against the EL insurers were not unconnected with the EL claimants' rights against the T&N companies; the scheme of arrangement involving the EL insurers was "an integral part of a single proposal affecting all the parties" (para. 52). He concluded his reasoning with these observations (para. 53):

> In my judgment it is not a necessary element of an arrangement for the purposes of s. 425 of the 1985 Act that it should alter the rights existing between the company and the creditors or members with whom it is made. No doubt in most cases it will alter those rights. But, provided that the context and content of the scheme are such as properly to constitute an arrangement between the company and the members or creditors concerned, it will fall within s. 425. It is ... neither necessary nor desirable to attempt a definition of arrangement. The legislature has not done so. To insist on an alteration of rights, or a termination of rights as in the case of schemes to effect takeovers or mergers, is to impose a restriction which is neither warranted by the statutory language nor justified by the courts' approach over many years to give the term its widest meaning. *Nor is an arrangement necessarily outside the section, because its effect is to alter the rights of creditors against another party or because such alteration could be achieved by a scheme of arrangement with that party.* [Emphasis added.]

**67** I find Richard J.'s analysis helpful and persuasive. In effect, the claimants in *T&N* were being asked to release their claims against the EL insurers in exchange for a call on the fund. Here, the appellants are being required to release their claims against certain financial third parties in exchange for

what is anticipated to be an improved position for all ABCP Noteholders, stemming from the contributions the financial third parties are making to the ABCP restructuring. The situations are quite comparable.

*The Binding Mechanism*

**68** Parliament's reliance on the expansive terms "compromise" or "arrangement" does not stand alone, however. Effective insolvency restructurings would not be possible without a statutory mechanism to bind an unwilling minority of creditors. Unanimity is frequently impossible in such situations. But the minority must be protected too. Parliament's solution to this quandary was to permit a wide range of proposals to be negotiated and put forward (the compromise or arrangement) and to bind all creditors by class to the terms of the plan, but to do so only where the proposal can gain the support of the requisite "double majority" of votes[6] and obtain the sanction of the court on the basis that it is fair and reasonable. In this way, the scheme of the CCAA supports the intention of Parliament to encourage a wide variety of solutions to corporate insolvencies without unjustifiably overriding the rights of dissenting creditors.

*The Required Nexus*

**69** In keeping with this scheme and purpose, I do not suggest that any and all releases between creditors of the debtor company seeking to restructure and third parties may be made the subject of a compromise or arrangement between the debtor and its creditors. Nor do I think the fact that the releases may be "necessary" in the sense that the third parties or the debtor may refuse to proceed without them, of itself, advances the argument in favour of finding jurisdiction (although it may well be relevant in terms of the fairness and reasonableness analysis).

**70** The release of the claim in question must be justified as part of the compromise or arrangement between the debtor and its creditors. In short, there must be a reasonable connection between the third party claim being compromised in the plan and the restructuring achieved by the plan to warrant inclusion of the third party release in the plan. This nexus exists here, in my view.

**71** In the course of his reasons, the application judge made the following findings, all of which are amply supported on the record:

a) The parties to be released are necessary and essential to the restructuring of the debtor;
b) *The claims to be released are rationally related to the purpose of the Plan and necessary for it*;
c) The Plan cannot succeed without the releases;
d) *The parties who are to have claims against them released are contributing in a tangible and realistic way to the Plan*; and
e) The Plan will benefit not only the debtor companies but creditor Noteholders generally.

**72** Here, then -- as was the case in *T&N* -- there is a close connection between the claims being released and the restructuring proposal. The tort claims arise out of the sale and distribution of the ABCP Notes and their collapse in value, just as do the contractual claims of the creditors against the debtor companies. The purpose of the restructuring is to stabilize and shore up the value of those notes in the long run. The third parties being released are making separate contributions to enable those results to materialize. Those contributions are identified earlier, at para. 31 of these reasons. The application judge found that the claims being released are not independent of or unrelated to the claims that the Noteholders have against the debtor companies; they are closely connected to the value of the ABCP Notes and are required for the Plan to succeed. At paras. 76-77 he said:

> [76] I do not consider that the Plan in this case involves a change in relationship among creditors "that does not directly involve the Company." Those who support the Plan and are to be released are "directly involved in the Company" in the sense that many are foregoing immediate rights to assets and are providing real and tangible input for the preservation and enhancement of the Notes. It would be unduly restrictive to suggest that the moving parties' claims against released parties do not involve the Company, since the claims are directly related to the value of the Notes. The value of the Notes is in this case the value of the Company.
>
> [77] This Plan, as it deals with releases, doesn't change the relationship of the creditors apart from involving the Company and its Notes.

**73** I am satisfied that the wording of the CCAA -- construed in light of the purpose, objects and scheme of the Act and in accordance with the modern principles of statutory interpretation -- supports the court's jurisdiction and authority to sanction the Plan proposed here, including the contested third-party releases contained in it.

<u>The Jurisprudence</u>

**74** Third party releases have become a frequent feature in Canadian restructurings since the decision of the Alberta Court of Queen's Bench in *Re Canadian Airlines Corp.* (2000), 265 A.R. 201, leave to appeal refused by *Resurgence Asset Management LLC v. Canadian Airlines Corp.* (2000), 266 A.R. 131 (C.A.), and [2001] S.C.C.A. No. 60, (2001) 293 A.R. 351 (S.C.C.). In *Re Muscle Tech Research and Development Inc.* (2006), 25 C.B.R (5th) 231 (Ont. S.C.J.) Justice Ground remarked (para. 8):

> [It] is not uncommon in CCAA proceedings, in the context of a plan of compromise and arrangement, to compromise claims against the Applicants and other parties against whom such claims or related claims are made.

**75** We were referred to at least a dozen court-approved CCAA plans from across the country that included broad third-party releases. With the exception of *Re Canadian Airlines*, however, the releases in those restructurings -- including *Muscle Tech* -- were not opposed. The appellants argue that those cases are wrongly decided, because the court simply does not have the authority to approve such releases.

**76** In *Re Canadian Airlines* the releases in question were opposed, however. Paperny J. (as she then was) concluded the court had jurisdiction to approve them and her decision is said to be the well-spring of the trend towards third-party releases referred to above. Based on the foregoing analysis, I agree with her conclusion although for reasons that differ from those cited by her.

**77** Justice Paperny began her analysis of the release issue with the observation at para. 87 that "[p]rior to 1997, the CCAA did not provide for compromises of claims against anyone other than the petitioning company." It will be apparent from the analysis in these reasons that I do not accept that premise, notwithstanding the decision of the Quebec Court of Appeal in *Michaud v. Steinberg,*[7] of which her comment may have been reflective. Paperny J.'s reference to 1997 was a reference to the amendments of that year adding s. 5.1 to the CCAA, which provides for limited releases in favour of directors. Given the limited scope of s. 5.1, Justice Paperny was thus faced with the argument -- dealt with later in these reasons -- that Parliament must not have intended to extend the authority to approve third-party releases beyond the scope of this section. She chose to address this contention by concluding that, although the amendments "[did] not authorize a release of claims against third parties other than directors, [they did] not prohibit such releases either" (para. 92).

**78** Respectfully, I would not adopt the interpretive principle that the CCAA permits releases because it does not expressly prohibit them. Rather, as I explain in these reasons, I believe the open-ended CCAA permits third-party releases that are reasonably related to the restructuring at issue because they are encompassed in the comprehensive terms "compromise" and "arrangement" and because of the double-voting majority and court sanctioning statutory mechanism that makes them binding on unwilling creditors.

**79** The appellants rely on a number of authorities, which they submit support the proposition that the CCAA may not be used to compromise claims as between anyone other than the debtor company and its creditors. Principal amongst these are *Michaud v. Steinberg, supra*; *NBD Bank, Canada v. Dofasco Inc.*, (1999), 46 O.R. (3d) 514 (C.A.); *Pacific Coastal Airlines Ltd. v. Air Canada* (2001), 19 B.L.R. (3d) 286 (B.C.S.C.); and *Re Stelco Inc.* (2005), 78 O.R. (3d) 241 (C.A.) ("*Stelco I*"). I do not think these cases assist the appellants, however. With the exception of *Steinberg*, they do not involve third party claims that were reasonably connected to the restructuring. As I shall explain, it is my opinion that *Steinberg* does not express a correct view of the law, and I decline to follow it.

**80** In *Pacific Coastal Airlines*, Tysoe J. made the following comment at para. 24:

> [The purpose of the CCAA proceeding] is not to deal with disputes between a creditor of a company and a third party, even if the company was also involved in the subject matter of the dispute. While issues between the debtor company and non-creditors are sometimes dealt with in CCAA proceedings, it is not a proper use of a CCAA proceeding to determine disputes between parties other than the debtor company.

**81** This statement must be understood in its context, however. Pacific Coastal Airlines had been a regional carrier for Canadian Airlines prior to the CCAA reorganization of the latter in 2000. In the action in question it was seeking to assert separate tort claims against Air Canada for contractual interference and inducing breach of contract in relation to certain rights it had to the use of Canadian's flight designator code prior to the CCAA proceeding. Air Canada sought to have the action dismissed on grounds of *res judicata* or issue estoppel because of the CCAA proceeding. Tysoe J. rejected the argument.

**82** The facts in *Pacific Coastal* are not analogous to the circumstances of this case, however. There is no suggestion that a resolution of Pacific Coastal's separate tort claim against Air Canada was in any way connected to the Canadian Airlines restructuring, even though Canadian -- at a contractual level -- may have had some involvement with the particular dispute. Here, however, the disputes that are the subject-matter of the impugned releases are not simply "disputes between parties other than the debtor company". They are closely connected to the disputes being resolved between the debtor companies and their creditors and to the restructuring itself.

**83** Nor is the decision of this Court in the *NBD Bank* case dispositive. It arose out of the financial collapse of Algoma Steel, a wholly-owned subsidiary of Dofasco. The Bank had advanced funds to Algoma allegedly on the strength of misrepresentations by Algoma's Vice-President, James Melville. The plan of compromise and arrangement that was sanctioned by Farley J. in the Algoma CCAA restructuring contained a clause releasing Algoma from all claims creditors "may have had against Algoma or its directors, officers, employees and advisors." Mr. Melville was found liable for negligent misrepresentation in a subsequent action by the Bank. On appeal, he argued that since the Bank was barred from suing Algoma for misrepresentation by its officers, permitting it to pursue the same cause of action against him personally would subvert the CCAA process -- in short, he was personally protected by the CCAA release.

**84** Rosenberg J.A., writing for this Court, rejected this argument. The appellants here rely particularly upon his following observations at paras. 53-54:

> 53 In my view, the appellant has not demonstrated that allowing the respondent to pursue its claim against him would undermine or subvert the purposes of the Act. As this court noted in *Elan Corp. v. Comiskey* (1990), 1 O.R. (3d) 289 at 297, the *CCAA* is remedial legislation "intended to provide a structured environment for the negotiation of compromises between a debtor company and its creditors for the benefit of both". It is a means of avoiding a liquidation that may yield little for the creditors, especially unsecured creditors like the respondent, and the debtor company shareholders. However, the appellant has not shown that allowing a creditor to continue an action against an officer for negligent misrepresentation would erode the effectiveness of the Act.
>
> 54 In fact, to refuse on policy grounds to impose liability on an officer of the corporation for negligent misrepresentation would contradict the policy of Parliament as demonstrated in recent amendments to the *CCAA* and the *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3. Those Acts now contemplate that an arrangement or proposal may include a term for compromise of certain types of claims against directors of the company except claims that "are based on allegations of misrepresentations made by directors". L.W. Houlden and C.H. Morawetz, the editors of *The 2000 Annotated Bankruptcy and Insolvency Act* (Toronto: Carswell, 1999) at p. 192 are of the view that the policy behind the provision is to encourage directors of an insolvent corporation to remain in office so that the affairs of the corporation can be reorganized. I can see no similar policy interest in barring an action against an officer of the company who, prior to the insolvency, has misrepresented the financial affairs of the corporation to its creditors. It may be necessary to permit the compromise of claims against the debtor corporation, otherwise it may not be possible to successfully reorganize the corporation. The same considerations do not apply to individual officers. Rather, it would seem to me that it would be contrary to good policy to immunize officers from the consequences of their negligent statements which might otherwise be made in anticipation of being forgiven under a subsequent corporate proposal or arrangement. [Footnote omitted.]

**85** Once again, this statement must be assessed in context. Whether Justice Farley had the authority in the earlier Algoma CCAA proceedings to sanction a plan that included third party releases was not under consideration at all. What the Court was determining in *NBD Bank* was whether the release extended by its terms to protect a third party. In fact, on its face, it does not appear to do so. Justice Rosenberg concluded only that not allowing Mr. Melville to rely upon the release did not subvert the purpose of the CCAA. As the application judge here observed, "there is little factual similarity in *NBD* to the facts now before the Court" (para. 71). Contrary to the facts of this case, in *NBD Bank* the creditors had not agreed to grant a release to officers; they had not voted on such a release and the court had not assessed the fairness and reasonableness of such a release as a term of a complex arrangement involving significant contributions by the beneficiaries of the release -- as is the situation here. Thus, *NBD Bank* is of little assistance in determining whether the court has authority to sanction a plan that calls for third party releases.

**86** The appellants also rely upon the decision of this Court in *Stelco I*. There, the Court was dealing with the scope of the CCAA in connection with a dispute over what were called the "Turnover Payments". Under an inter-creditor agreement one group of creditors had subordinated their rights to

another group and agreed to hold in trust and "turn over" any proceeds received from Stelco until the senior group was paid in full. On a disputed classification motion, the Subordinated Debt Holders argued that they should be in a separate class from the Senior Debt Holders. Farley J. refused to make such an order in the court below, stating:

> [Sections] 4, 5 and 6 [of the CCAA] talk of compromises or arrangements between a company and its creditors. There is no mention of this extending by statute to encompass a change of relationship among the creditors vis-à-vis the creditors themselves *and not directly involving the company.* [Citations omitted; emphasis added.]
>
> See *Re Stelco Inc.* (2005), 15 C.B.R. (5th) 297 (Ont. S.C.J.) at para. 7.

**87** This Court upheld that decision. The legal relationship between each group of creditors and Stelco was the same, albeit there were inter-creditor differences, and creditors were to be classified in accordance with their legal rights. In addition, the need for timely classification and voting decisions in the CCAA process militated against enmeshing the classification process in the vagaries of inter-corporate disputes. In short, the issues before the Court were quite different from those raised on this appeal.

**88** Indeed, the Stelco plan, as sanctioned, included third party releases (albeit uncontested ones). This Court subsequently dealt with the same inter-creditor agreement on an appeal where the Subordinated Debt Holders argued that the inter-creditor subordination provisions were beyond the reach of the CCAA and therefore that they were entitled to a separate civil action to determine their rights under the agreement: *Re Stelco Inc.*, (2006), 21 C.B.R. (5th) 157 (Ont. C.A.) ("*Stelco II*"). The Court rejected that argument and held that where the creditors' rights amongst themselves were sufficiently related to the debtor and its plan, they were properly brought within the scope of the CCAA plan. The Court said (para. 11):

> In [*Stelco I*] -- the classification case -- the court observed that it is not a proper use of a CCAA proceeding to determine disputes between parties other than the debtor company ... *[H]owever, the present case is not simply an inter-creditor dispute that does not involve the debtor company; it is a dispute that is inextricably connected to the restructuring process.* [Emphasis added.]

**89** The approach I would take to the disposition of this appeal is consistent with that view. As I have noted, the third party releases here are very closely connected to the ABCP restructuring process.

**90** Some of the appellants -- particularly those represented by Mr. Woods -- rely heavily upon the decision of the Quebec Court of Appeal in *Michaud v. Steinberg, supra*. They say that it is determinative of the release issue. In *Steinberg*, the Court held that the CCAA, as worded at the time, did not permit the release of directors of the debtor corporation and that third-party releases were not within the purview of the Act. Deschamps J.A. (as she then was) said (paras. 42, 54 and 58 -- English translation):

> [42] Even if one can understand the extreme pressure weighing on the creditors and the respondent at the time of the sanctioning, a plan of arrangement is not the appropriate forum to settle disputes other than the claims that are the subject of the arrangement. In other words, one cannot, under the pretext of an absence of formal directives in the Act, transform an arrangement into a potpourri.
>
> ...

> [54] The Act offers the respondent a way to arrive at a compromise with is creditors. It does not go so far as to offer an umbrella to all the persons within its orbit by permitting them to shelter themselves from any recourse.
>
> ...
>
> [58] The [CCAA] and the case law clearly do not permit extending the application of an arrangement to persons other than the respondent and its creditors and, consequently, the plan should not have been sanctioned as is [that is, including the releases of the directors].

**91** Justices Vallerand and Delisle, in separate judgments, agreed. Justice Vallerand summarized his view of the consequences of extending the scope of the CCAA to third party releases in this fashion (para. 7):

> In short, the Act will have become the Companies' *and Their Officers and Employees* Creditors Arrangement Act -- an awful mess -- and likely not attain its purpose, which is to enable the company to survive in the face of *its* creditors and through their will, and not in the face of the creditors of its officers. This is why I feel, just like my colleague, that such a clause is contrary to the Act's mode of operation, contrary to its purposes and, for this reason, is to be banned.

**92** Justice Delisle, on the other hand, appears to have rejected the releases because of their broad nature -- they released directors from all claims, including those that were altogether unrelated to their corporate duties with the debtor company -- rather than because of a lack of authority to sanction under the Act. Indeed, he seems to have recognized the wide range of circumstances that could be included within the term "compromise or arrangement". He is the only one who addressed that term. At para. 90 he said:

> The CCAA is drafted in general terms. It does not specify, among other things, what must be understood by "compromise or arrangement". However, it may be inferred from the purpose of this [A]ct that these terms *encompass all that should enable the person who has recourse to it to fully dispose of his debts*, both those that exist on the date when he has recourse to the statute and *those contingent on the insolvency in which he finds himself* ... [Emphasis added.]

**93** The decision of the Court did not reflect a view that the terms of a compromise or arrangement should "encompass all that should enable the person who has recourse to [the Act] to dispose of his debts ... and those contingent on the insolvency in which he finds himself," however. On occasion such an outlook might embrace third parties other than the debtor and its creditors in order to make the arrangement work. Nor would it be surprising that, in such circumstances, the third parties might seek the protection of releases, or that the debtor might do so on their behalf. Thus, the perspective adopted by the majority in *Steinberg*, in my view, is too narrow, having regard to the language, purpose and objects of the CCAA and the intention of Parliament. They made no attempt to consider and explain why a compromise or arrangement could not include third-party releases. In addition, the decision appears to have been based, at least partly, on a rejection of the use of contract-law concepts in analysing the Act -- an approach inconsistent with the jurisprudence referred to above.

**94** Finally, the majority in *Steinberg* seems to have proceeded on the basis that the CCAA cannot interfere with civil or property rights under Quebec law. Mr. Woods advanced this argument before this

Court in his factum, but did not press it in oral argument. Indeed, he conceded that if the Act encompasses the authority to sanction a plan containing third-party releases -- as I have concluded it does -- the provisions of the CCAA, as valid federal insolvency legislation, are paramount over provincial legislation. I shall return to the constitutional issues raised by the appellants later in these reasons.

**95** Accordingly, to the extent *Steinberg* stands for the proposition that the court does not have authority under the CCAA to sanction a plan that incorporates third-party releases, I do not believe it to be a correct statement of the law and I respectfully decline to follow it. The modern approach to interpretation of the Act in accordance with its nature and purpose militates against a narrow interpretation and towards one that facilitates and encourages compromises and arrangements. Had the majority in *Steinberg* considered the broad nature of the terms "compromise" and "arrangement" and the jurisprudence I have referred to above, they might well have come to a different conclusion.

The 1997 Amendments

**96** *Steinberg* led to amendments to the CCAA, however. In 1997, s. 5.1 was added, dealing specifically with releases pertaining to directors of the debtor company. It states:

> 5.1 (1) A compromise or arrangement made in respect of a debtor company may include in its terms provision for the compromise of claims against directors of the company that arose before the commencement of proceedings under this Act and that relate to the obligations of the company where the directors are by law liable in their capacity as directors for the payment of such obligations.
>
> Exception
>
> (2) A provision for the compromise of claims against directors may not include claims that
>
> (*a*) relate to contractual rights of one or more creditors; or
>
> (*b*) are based on allegations of misrepresentations made by directors to creditors or of wrongful or oppressive conduct by directors.
>
> Powers of court
>
> (3) The court may declare that a claim against directors shall not be compromised if it is satisfied that the compromise would not be fair and reasonable in the circumstances.
>
> Resignation or removal of directors
>
> (4) Where all of the directors have resigned or have been removed by the shareholders without replacement, any person who manages or supervises the management of the business and affairs of the debtor company shall be deemed to be a director for the purposes of this section.

1997, c. 12, s. 122.

**97** Perhaps the appellants' strongest argument is that these amendments confirm a prior lack of authority in the court to sanction a plan including third party releases. If the power existed, why would

Parliament feel it necessary to add an amendment specifically permitting such releases (subject to the exceptions indicated) in favour of directors? *Expressio unius est exclusio alterius*, is the Latin maxim sometimes relied on to articulate the principle of interpretation implied in that question: to express or include one thing implies the exclusion of the other.

**98** The maxim is not helpful in these circumstances, however. The reality is that there *may* be another explanation why Parliament acted as it did. As one commentator has noted:[8]

> Far from being a rule, [the maxim *expressio unius*] is not even lexicographically accurate, because it is simply not true, generally, that the mere express conferral of a right or privilege in one kind of situation implies the denial of the equivalent right or privilege in other kinds. Sometimes it does and sometimes its does not, and whether it does or does not depends on the particular circumstances of context. Without contextual support, therefore there is not even a mild presumption here. Accordingly, the maxim is at best a description, after the fact, of what the court has discovered from context.

**99** As I have said, the 1997 amendments to the CCAA providing for releases in favour of directors of debtor companies in limited circumstances were a response to the decision of the Quebec Court of Appeal in *Steinberg*. A similar amendment was made with respect to proposals in the BIA at the same time. The rationale behind these amendments was to encourage directors of an insolvent company to remain in office during a restructuring, rather than resign. The assumption was that by remaining in office the directors would provide some stability while the affairs of the company were being reorganized: see Houlden and Morawetz, vol. 1, *supra*, at 2-144, Es.11A; *Le Royal Penfield Inc. (Syndic de)*, [2003] R.J.Q. 2157 at paras. 44-46 (C.S.).

**100** Parliament thus had a particular focus and a particular purpose in enacting the 1997 amendments to the CCAA and the BIA. While there is some merit in the appellants' argument on this point, at the end of the day I do not accept that Parliament intended to signal by its enactment of s. 5.1 that it was depriving the court of authority to sanction plans of compromise or arrangement in all circumstances where they incorporate third party releases in favour of anyone other than the debtor's directors. For the reasons articulated above, I am satisfied that the court does have the authority to do so. Whether it sanctions the plan is a matter for the fairness hearing.

The Deprivation of Proprietary Rights

**101** Mr. Shapray very effectively led the appellants' argument that legislation must not be construed so as to interfere with or prejudice established contractual or proprietary rights -- including the right to bring an action -- in the absence of a clear indication of legislative intention to that effect: *Halsbury's Laws of England*, 4th ed. reissue, vol. 44 (1) (London: Butterworths, 1995) at paras. 1438, 1464 and 1467; Driedger, 2nd ed., *supra,* at 183; Ruth Sullivan, *Sullivan and Driedger on the Construction of Statutes*, 4th ed., (Markham: Butterworths, 2002) at 399. I accept the importance of this principle. For the reasons I have explained, however, I am satisfied that Parliament's intention to clothe the court with authority to consider and sanction a plan that contains third party releases is expressed with sufficient clarity in the "compromise or arrangement" language of the CCAA coupled with the statutory voting and sanctioning mechanism making the provisions of the plan binding on all creditors. This is not a situation of impermissible "gap-filling" in the case of legislation severely affecting property rights; it is a question of finding meaning in the language of the Act itself. I would therefore not give effect to the appellants' submissions in this regard.

The Division of Powers and Paramountcy

**102** Mr. Woods and Mr. Sternberg submit that extending the reach of the CCAA process to the compromise of claims as between solvent creditors of the debtor company and solvent third parties to the proceeding is constitutionally impermissible. They say that under the guise of the federal insolvency power pursuant to s. 91(21) of the *Constitution Act, 1867*, this approach would improperly affect the rights of civil claimants to assert their causes of action, a provincial matter falling within s. 92(13), and contravene the rules of public order pursuant to the *Civil Code of Quebec*.

**103** I do not accept these submissions. It has long been established that the CCAA is valid federal legislation under the federal insolvency power: *Reference re: Companies' Creditors Arrangement Act (Canada)*, [1934] S.C.R. 659. As the Supreme Court confirmed in that case (p. 661), citing Viscount Cave L.C. in *Royal Bank of Canada v. Larue* [1928] A.C. 187, "the exclusive legislative authority to deal with all matters within the domain of bankruptcy and insolvency is vested in Parliament." Chief Justice Duff elaborated:

> Matters normally constituting part of a bankruptcy scheme but not in their essence matters of bankruptcy and insolvency may, of course, from another point of view and in another aspect be dealt with by a provincial legislature; but, when treated as matters pertaining to bankruptcy and insolvency, they clearly fall within the legislative authority of the Dominion.

**104** That is exactly the case here. The power to sanction a plan of compromise or arrangement that contains third-party releases of the type opposed by the appellants is embedded in the wording of the CCAA. The fact that this may interfere with a claimant's right to pursue a civil action -- normally a matter of provincial concern -- or trump Quebec rules of public order is constitutionally immaterial. The CCAA is a valid exercise of federal power. Provided the matter in question falls within the legislation directly or as necessarily incidental to the exercise of that power, the CCAA governs. To the extent that its provisions are inconsistent with provincial legislation, the federal legislation is paramount. Mr. Woods properly conceded this during argument.

Conclusion With Respect to Legal Authority

**105** For all of the foregoing reasons, then, I conclude that the application judge had the jurisdiction and legal authority to sanction the Plan as put forward.

### (2) The Plan is "Fair and Reasonable"

**106** The second major attack on the application judge's decision is that he erred in finding that the Plan is "fair and reasonable" and in sanctioning it on that basis. This attack is centred on the nature of the third-party releases contemplated and, in particular, on the fact that they will permit the release of some claims based in fraud.

**107** Whether a plan of compromise or arrangement is fair and reasonable is a matter of mixed fact and law, and one on which the application judge exercises a large measure of discretion. The standard of review on this issue is therefore one of deference. In the absence of a demonstrable error an appellate court will not interfere: see *Re Ravelston Corp. Ltd.* (2007), 31 C.B.R. (5th) 233 (Ont. C.A.).

**108** I would not interfere with the application judge's decision in this regard. While the notion of releases in favour of third parties -- including leading Canadian financial institutions -- that extend to claims of fraud is distasteful, there is no legal impediment to the inclusion of a release for claims based in fraud in a plan of compromise or arrangement. The application judge had been living with and supervising the ABCP restructuring from its outset. He was intimately attuned to its dynamics. In the

end he concluded that the benefits of the Plan to the creditors as a whole, and to the debtor companies, outweighed the negative aspects of compelling the unwilling appellants to execute the releases as finally put forward.

**109** The application judge was concerned about the inclusion of fraud in the contemplated releases and at the May hearing adjourned the final disposition of the sanctioning hearing in an effort to encourage the parties to negotiate a resolution. The result was the "fraud carve-out" referred to earlier in these reasons.

**110** The appellants argue that the fraud carve-out is inadequate because of its narrow scope. It (i) applies only to ABCP Dealers, (ii) limits the type of damages that may be claimed (no punitive damages, for example), (iii) defines "fraud" narrowly, excluding many rights that would be protected by common law, equity and the Quebec concept of public order, and (iv) limits claims to representations made directly to Noteholders. The appellants submit it is contrary to public policy to sanction a plan containing such a limited restriction on the type of fraud claims that may be pursued against the third parties.

**111** The law does not condone fraud. It is the most serious kind of civil claim. There is therefore some force to the appellants' submission. On the other hand, as noted, there is no legal impediment to granting the release of an antecedent claim in fraud, provided the claim is in the contemplation of the parties to the release at the time it is given: *Fotinis Restaurant Corp. v. White Spot Ltd.* (1998), 38 B.L.R. (2d) 251 at paras. 9 and 18 (B.C.S.C.). There may be disputes about the scope or extent of what is released, but parties are entitled to settle allegations of fraud in civil proceedings -- the claims here all being untested allegations of fraud -- and to include releases of such claims as part of that settlement.

**112** The application judge was alive to the merits of the appellants' submissions. He was satisfied in the end, however, that the need "to avoid the potential cascade of litigation that ... would result if a broader 'carve out' were to be allowed" (para. 113) outweighed the negative aspects of approving releases with the narrower carve-out provision. Implementation of the Plan, in his view, would work to the overall greater benefit of the Noteholders as a whole. I can find no error in principle in the exercise of his discretion in arriving at this decision. It was his call to make.

**113** At para. 71 above I recited a number of factual findings the application judge made in concluding that approval of the Plan was within his jurisdiction under the CCAA and that it was fair and reasonable. For convenience, I reiterate them here -- with two additional findings -- because they provide an important foundation for his analysis concerning the fairness and reasonableness of the Plan. The application judge found that:

a) The parties to be released are necessary and essential to the restructuring of the debtor;
b) The claims to be released are rationally related to the purpose of the Plan and necessary for it;
c) The Plan cannot succeed without the releases;
d) The parties who are to have claims against them released are contributing in a tangible and realistic way to the Plan;
e) The Plan will benefit not only the debtor companies but creditor Noteholders generally;
f) The voting creditors who have approved the Plan did so with knowledge of the nature and effect of the releases; and that,
g) The releases are fair and reasonable and not overly broad or offensive to public policy.

**114** These findings are all supported on the record. Contrary to the submission of some of the appellants, they do not constitute a new and hitherto untried "test" for the sanctioning of a plan under the CCAA. They simply represent findings of fact and inferences on the part of the application judge that underpin his conclusions on jurisdiction and fairness.

**115** The appellants all contend that the obligation to release the third parties from claims in fraud, tort, breach of fiduciary duty, etc. is confiscatory and amounts to a requirement that they -- as individual creditors -- make the equivalent of a greater financial contribution to the Plan. In his usual lively fashion, Mr. Sternberg asked us the same rhetorical question he posed to the application judge. As he put it, how could the court countenance the compromise of what in the future might turn out to be fraud perpetrated at the highest levels of Canadian and foreign banks? Several appellants complain that the proposed Plan is unfair to them because they will make very little additional recovery if the Plan goes forward, but will be required to forfeit a cause of action against third-party financial institutions that may yield them significant recovery. Others protest that they are being treated unequally because they are ineligible for relief programs that Liquidity Providers such as Canaccord have made available to other smaller investors.

**116** All of these arguments are persuasive to varying degrees when considered in isolation. The application judge did not have that luxury, however. He was required to consider the circumstances of the restructuring as a whole, including the reality that many of the financial institutions were not only acting as Dealers or brokers of the ABCP Notes (with the impugned releases relating to the financial institutions in these capacities, for the most part) but also as Asset and Liquidity Providers (with the financial institutions making significant contributions to the restructuring in these capacities).

**117** In insolvency restructuring proceedings almost everyone loses something. To the extent that creditors are required to compromise their claims, it can always be proclaimed that their rights are being unfairly confiscated and that they are being called upon to make the equivalent of a further financial contribution to the compromise or arrangement. Judges have observed on a number of occasions that CCAA proceedings involve "a balancing of prejudices," inasmuch as everyone is adversely affected in some fashion.

**118** Here, the debtor corporations being restructured represent the issuers of the more than $32 billion in non-bank sponsored ABCP Notes. The proposed compromise and arrangement affects that entire segment of the ABCP market and the financial markets as a whole. In that respect, the application judge was correct in adverting to the importance of the restructuring to the resolution of the ABCP liquidity crisis and to the need to restore confidence in the financial system in Canada. He was required to consider and balance the interests of <u>all</u> Noteholders, not just the interests of the appellants, whose notes represent only about 3% of that total. That is what he did.

**119** The application judge noted at para. 126 that the Plan represented "a reasonable balance between benefit to all Noteholders and enhanced recovery for those who can make out specific claims in fraud" within the fraud carve-out provisions of the releases. He also recognized at para. 134 that:

> No Plan of this size and complexity could be expected to satisfy all affected by it. The size of the majority who have approved it is testament to its overall fairness. No plan to address a crisis of this magnitude can work perfect equity among all stakeholders.

**120** In my view we ought not to interfere with his decision that the Plan is fair and reasonable in all the circumstances.

**D. DISPOSITION**

**121** For the foregoing reasons, I would grant leave to appeal from the decision of Justice Campbell, but dismiss the appeal.

R.A. BLAIR J.A.
J.I. LASKIN J.A.:-- I agree.
E.A. CRONK J.A.:-- I agree.

* * * * *

**SCHEDULE "A" - CONDUITS**

Apollo Trust

Apsley Trust

Aria Trust

Aurora Trust

Comet Trust

Encore Trust

Gemini Trust

Ironstone Trust

MMAI-I Trust

Newshore Canadian Trust

Opus Trust

Planet Trust

Rocket Trust

Selkirk Funding Trust

Silverstone Trust

Slate Trust

Structured Asset Trust

Structured Investment Trust III

Symphony Trust

Whitehall Trust

* * * * *

## SCHEDULE "B" - APPLICANTS

ATB Financial

Caisse de Dépôt et Placement du Québec

Canaccord Capital Corporation

Canada Post Corporation

Credit Union Central of Alberta Limited

Credit Union Central of British Columbia

Credit Union Central of Canada

Credit Union Central of Ontario

Credit Union Central of Saskatchewan

Desjardins Group

Magna International Inc.

National Bank Financial Inc./National Bank of Canada

NAV Canada

Northwater Capital Management Inc.

Public Sector Pension Investment Board

The Governors of the University of Alberta

* * * * *

## SCHEDULE "A" - COUNSEL

1) Benjamin Zarnett and Frederick L. Myers for the Pan-Canadian Investors Committee.
2) Aubrey E. Kauffman and Stuart Brotman for 4446372 Canada Inc. and 6932819 Canada Inc.
3) Peter F.C. Howard and Samaneh Hosseini for Bank of America N.A.; Citibank N.A.; Citibank Canada, in its capacity as Credit Derivative Swap Counterparty and not in any other capacity; Deutsche Bank AG; HSBC Bank Canada; HSBC Bank USA, National Association; Merrill Lynch International; Merill Lynch Capital Services, Inc.; Swiss Re Financial Products Corporation; and UBS AG.
4) Kenneth T. Rosenberg, Lily Harmer and Max Starnino for Jura Energy Corporation and Redcorp Ventures Ltd.
5) Craig J. Hill and Sam P. Rappos for the Monitors (ABCP Appeals).
6) Jeffrey C. Carhart and Joseph Marin for Ad Hoc Committee and Pricewaterhouse Coopers Inc., in its capacity as Financial Advisor.

7) Mario J. Forte for Caisse de Dépôt et Placement du Québec.
8) John B. Laskin for National Bank Financial Inc. and National Bank of Canada.
9) Thomas McRae and Arthur O. Jacques for Ad Hoc Retail Creditors Committee (Brian Hunter, et al).
10) Howard Shapray, Q.C. and Stephen Fitterman for Ivanhoe Mines Ltd.
11) Kevin P. McElcheran and Heather L. Meredith for Canadian Banks, BMO, CIBC RBC, Bank of Nova Scotia and T.D. Bank.
12) Jeffrey S. Leon for CIBC Mellon Trust Company, Computershare Trust Company of Canada and BNY Trust Company of Canada, as Indenture Trustees.
13) Usman Sheikh for Coventree Capital Inc.
14) Allan Sternberg and Sam R. Sasso for Brookfield Asset Management and Partners Ltd. and Hy Bloom Inc. and Cardacian Mortgage Services Inc.
15) Neil C. Saxe for Dominion Bond Rating Service.
16) James A. Woods, Sebastien Richemont and Marie-Anne Paquette for Air Transat A.T. Inc., Transat Tours Canada Inc., The Jean Coutu Group (PJC) Inc., Aéroports de Montréal, Aéroports de Montréal Capital Inc., Pomerleau Ontario Inc., Pomerleau Inc., Labopharm Inc., Agence Métropolitaine de Transport (AMT), Giro Inc., Vêtements de sports RGR Inc., 131519 Canada Inc., Tecsys Inc., New Gold Inc. and Jazz Air LP.
17) Scott A. Turner for Webtech Wireless Inc., Wynn Capital Corporation Inc., West Energy Ltd., Sabre Energy Ltd., Petrolifera Petroleum Ltd., Vaquero Resources Ltd., and Standard Energy Ltd.
18) R. Graham Phoenix for Metcalfe & Mansfield Alternative Investments II Corp., Metcalfe & Mansfield Alternative Investments III Corp., Metcalfe & Mansfield Alternative Investments V Corp., Metcalfe & Mansfield Alternative Investments XI Corp., Metcalfe & Mansfield Alternative Investments XII Corp., Quanto Financial Corporation and Metcalfe & Mansfield Capital Corp.

cp/e/ln/qlkxl/qllkb/qlltl/qlrxg/qlhcs/qlcas/qlhcs/qlhcs

1 Section 5.1 of the CCAA specifically authorizes the granting of releases to directors in certain circumstances.

2 Justice Georgina R. Jackson and Dr. Janis P. Sarra, "Selecting the Judicial Tool to get the Job Done: An Examination of Statutory Interpretation, Discretionary Power and Inherent Jurisdiction in Insolvency Matters" in Sarra, ed., *Annual Review of Insolvency Law, 2007* (Vancouver: Thomson Carswell, 2007).

3 Citing Gibbs J.A. in *Chef Ready Foods, supra,* at pp. 319-320.

4 The Legislative Debates at the time the CCAA was introduced in Parliament in April 1933 make it clear that the CCAA is patterned after the predecessor provisions of s. 425 of the *Companies Act 1985* (U.K.): see *House of Commons Debates (Hansard), supra.*

5 See *Canada Business Corporations Act*, R.S.C. 1985, c. C-44, s. 192; *Ontario Business*

*Corporations Act,* R.S.O. 1990, c. B.16, s. 182.

6 A majority in number representing two-thirds in value of the creditors (s. 6).

7 *Steinberg* was originally reported in French: [1993] R.J.Q. 1684 (C.A.). All paragraph references to *Steinberg* in this judgment are from the unofficial English translation available at 1993 CarswellQue 2055.

8 Reed Dickerson, *The Interpretation and Application of Statutes* (1975) at pp. 234-235, cited in Bryan A. Garner, ed., Black's Law Dictionary, 8th ed. (West Group, St. Paul, Minn., 2004) at 621.

# TAB 2

*Case Name:*

**Alternative Fuel Systems Inc. v. Remington Development Corp.**

**IN THE MATTER OF the Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36 as amended**
**AND IN THE MATTER OF Alternative Fuels Inc.**
**Between**
**Remington Development Corporation, respondent (applicant), and**
**Alternative Fuel Systems Inc., appellant (respondent)**

[2004] A.J. No. 60

2004 ABCA 31

236 D.L.R. (4th) 155

[2004] 5 W.W.R. 475

24 Alta. L.R. (4th) 1

346 A.R. 28

47 C.B.R. (4th) 1

128 A.C.W.S. (3d) 804

2004 CarswellAlta 64

Docket No.: 0301-0270-AC

Alberta Court of Appeal
Calgary, Alberta

**McFadyen and Paperny JJ.A. and Clark J. (ad hoc)**

Heard: December 2, 2003.
Judgment: filed January 29, 2004.

(70 paras.)

*Creditors & Debtors Law -- Legislation -Debtors' relief -- Companies Creditors Arrangement Act -- Insolvency Law -- Claims -- Provable claims -- Legislation -Bankruptcy and Insolvency Act - Interpretation -- Landlord and Tenant Law -- The lease -- Bankruptcy, effect of.*

Appeal by the appellant tenant alleging that the debt of the landlord was limited by application of the statute the Landlord's Rights on Bankruptcy Act because the tenant had received protection under the Companies' Creditors Arrangement Act. The chambers judge held that the statute did not automatically apply to limit or quantify the landlord's claim.

Held: Appeal dismissed. The standard of review was correctness. The chambers judge had not erred. There was no specific statutory direction nor demonstrated need to import statutory provisions which might have had a negative effect on the flexibility afforded by the Companies' Creditors Arrangement Act.

**Statutes, Regulations and Rules Cited:**

Bankruptcy and Insolvency Act, ss. 65.2, 65.2(4), 73(4), 136, 136(f), 146.

Companies' Creditors Arrangement Act, ss. s. 12(1), 12(2), 12(2)(a)(iii).

Landlord's Rights on Bankruptcy Act, ss. 1, 2, 3, 4, 12.

**Appeal From:**

On appeal from the order of LoVecchio J., dated September 2, 2003 and filed September 17, 2003. (2003 ABQB 745, Docket: 0301-05678)

**Counsel:**

B.P. O'Leary, Q.C. and C. Murray, for the appellant.
L.B. Robinson, for the respondent.
R.J. Gilborn, Q.C., for the Monitor.

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[Editor's note: A Corrigendum was released by the Court April 13, 2004. The corrections have been made to the text and the Corrigendum is appended to this document.]

REASONS FOR JUDGMENT

Reasons for judgment were delivered by Paperny J.A. Concurred in by McFadyen J.A. and Clark J.

PAPERNEY J.A.:--

Introduction

**1** This appeal raises a pure question of law: Does the Landlord's Rights on Bankruptcy Act, R.S.A. 2000, c. L-5 (LRBA) apply to the determination of a landlord's claim when the debtor tenant has received protection under the Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36 (CCAA).

Facts

**2** The respondent, Remington Development Corporation (Remington) is agent for the landlord of the appellant, Alternative Fuel Systems Inc. (AFS). Remington had two agreements with AFS to lease

commercial space in Calgary from August 1, 2000 to January 31, 2016. Finding itself in financial difficulty, AFS petitioned and on April 9, 2003 received the order that it was a company to which the CCAA applies and could file a plan of compromise or arrangement under the CCAA. As part of its restructuring, AFS surrendered the leased premises to Remington in May 2003.

**3** Both Remington and AFS sought a valuation of the landlord's claim and a determination whether, as an unsecured creditor, the claim should form part of the unsecured creditor class in the CCAA. Before the chambers judge, AFS calculated Remington's claim under the LRBA was approximately $96,000 without considering offsets for prepaid rent and other items. On a full accounting, the sum could be further reduced to $15,000. A non-discounted mitigated claim for the unexpired term of the leases would be about $4.2 million, although, as a result of mitigation the largest portion of Remington's claim has now been reduced to $1.1 million while the smaller portion currently remains at $400,000.

**4** The chambers judge held that the LRBA does not automatically apply to limit or quantify the landlord's claim in CCAA proceedings.

Appellant's position

**5** The thrust of the appellant's submission, broadly stated, is that under the CCAA the amount of a landlord's claim in Alberta is the same amount as would be calculated in a bankruptcy. More specifically, the appellant submits that an unbreakable thread connects the CCAA to the LRBA. The thread begins with the plain meaning of s. 12(1) of the CCAA which refers to the Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3 (BIA) to define claims under the CCAA. The thread continues to s. 12(2) of the CCAA which provides for a determination of the amount represented by a claim in three different ways. In this appeal, the applicable sub-clause, s. 12(2)(a)(iii) provides that amount is that which might be proven under the BIA. A third link is s. 136 of the BIA which sets a priority for payment to a bankrupt's creditors and specifically, s. 136(f), which includes a landlord for priority payment, but limits the amount which may be claimed by a landlord. The next connection, says the appellant, is s. 146 of the BIA which further provides that in addition to ss. 136 and 73(4) of the BIA, rights of landlords are determined according to the law of the province in which leased premises are situated. In Alberta, that law includes the LRBA which further limits a landlord's rights in bankruptcy. Through this series of statutory provisions, it submits Parliament has provided that the landlord's rights under the CCAA are identical to those under the BIA and thus, under the LRBA.

Relevant legislation

**6** The relevant provision in the CCAA is s. 12 which provides:

> 12. (1) For the purposes of this Act, "claim" means any indebtedness, liability or obligation of any kind that, if unsecured, would be a debt provable in bankruptcy within the meaning of the Bankruptcy and Insolvency Act.
>
> Determination of amount of claim
>
> (2) For the purposes of this Act, the amount represented by a claim of any secured or unsecured creditor shall be determined as follows:
>
> (a) the amount of an unsecured claim shall be the amount
>
> (i) in the case of a company in the course of being wound up under the Winding-up and Restructuring Act, proof of which has been made in accordance with that Act,

(ii) in the case of a company that has made an authorized assignment or against which a receiving order has been made under the Bankruptcy and Insolvency Act, proof of which has been made in accordance with that Act, or

(iii) in the case of any other company, proof of which might be made under the Bankruptcy and Insolvency Act, but if the amount so provable is not admitted by the company, the amount shall be determined by the court on summary application by the company or by the creditor; and

(b) the amount of a secured claim shall be the amount, proof of which might be made in respect thereof under the Bankruptcy and Insolvency Act if the claim were unsecured, but the amount if not admitted by the company shall, in the case of a company subject to pending proceedings under the Winding-up and Restructuring Act or the Bankruptcy and Insolvency Act, be established by proof in the same manner as an unsecured claim under the Winding-up and Restructuring Act or the Bankruptcy and Insolvency Act, as the case may be, and in the case of any other company the amount shall be determined by the court on summary application by the company or the creditor.

Admission of claims

(3) Notwithstanding subsection (2), the company may admit the amount of a claim for voting purposes under reserve of the right to contest liability on the claim for other purposes, and nothing in this Act, the Winding-up and Restructuring Act or the Bankruptcy and Insolvency Act prevents a secured creditor from voting at a meeting of secured creditors or any class of them in respect of the total amount of a claim as admitted.

7 The following provisions in the BIA are also relevant:

Scheme of Distribution

Priority of claims

136. (1) Subject to the rights of secured creditors, the proceeds realized from the property of a bankrupt shall be applied in priority of payment as follows:

...

(f) the landlord for arrears of rent for a period of three months immediately preceding the bankruptcy and accelerated rent for a period not exceeding three months following the bankruptcy if entitled thereto under the lease, but the total amount so payable shall not exceed the realization from the property on the premises under lease, and any payment made on account of accelerated rent shall be credited against the amount payable by the trustee for occupation rent;

...

Application of provincial law to landlords' rights

146. Subject to priority of ranking as provided by section 136 and subject to subsection 73

(4), the rights of landlords shall be determined according to the laws of the province in which the leased premises are situated.

**8** The provisions in the LRBA which the appellant submits are relevant are:

Assignment of property

1 A lessee against or by whom a receiving order or assignment is made under the Bankruptcy and Insolvency Act (Canada) is deemed to have made an assignment of all the lessee's property for the general benefit of the lessee's creditors before the date of the receiving order or assignment.

Payment of rent after assignment

2 As soon as the receiving order or assignment is made

(a) the landlord of the lessee is not afterwards entitled to distrain or realize the rent by distress, and
(b) the trustee in whom the property of the lessee vests under the Bankruptcy and Insolvency Act (Canada) shall pay to the landlord in priority to all other debts

(i) an amount not exceeding in value the distrainable assets of the lessee and not exceeding 3 months' rent accrued due before the date of the receiving order or assignment, and
(ii) the costs of distress, if any.

Surplus rent

3 The lessee is a debtor to the landlord

(a) for all surplus rent in excess of the 3 months' rent accrued due at the date of the receiving order or assignment, and
(b) for any accelerated rent to which the landlord may be entitled under the lease but not exceeding an amount equal to 3 months' rent.

When landlord unable to claim from lessee

4 Subject to section 3, the landlord has no right to claim as a debt any money due to the landlord from the lessee for any portion of the unexpired term of the lessee's lease.

Analysis

**9** As a pure question of law, the standard of review is correctness. I agree with the Chambers Judge that the LRBA does not apply to limit or quantify the landlord's claim in CCAA proceedings.

10 I arrive at this conclusion on the basis, first, that the condition precedent set out in the LRBA for its application (and mirrored in its correlative, Part II of the BIA, which deals with Receiving Orders and Assignments) is not satisfied when the debtor is not the subject of a receiving order or an assignment, nor does the LRBA fit within the scheme and intent of the CCAA. Second, the interpretation of s. 12 of the CCAA does not direct the importation of all the provisions of the BIA into the CCAA when determining the amount of the claim. Third and most significantly, the objects of the BIA and CCAA are distinct and each must be interpreted with their respective purposes in mind.

The condition precedent for application of the LRBA

11 That provincial legislation can deal with a landlord's rights upon the bankruptcy of a tenant if it does not conflict with the BIA (Principal Plaza Leasehold Ltd. v. Principal Group Ltd. (1996), 188 A.R. 187 (Q.B.)) is not in dispute. There is no question that the LRBA properly operates within a bankruptcy context, when the debtor is the subject of either a receiving order or an assignment.

12 In such a case, s. 136(1)(f) of the BIA confers on the landlord a preferred claim for arrears of rent for a specified period and provincial legislation is called into operation pursuant to s. 146. Consequently the LRBA's provisions are invoked.

13 The appellant seeks to invoke these provisions when a debtor is not the subject of a receiving order or an assignment, but rather, proposes a plan of arrangement under the CCAA. In my view, the LRBA's provisions are not invoked in such circumstances.

14 The LRBA sets out the conditions under which the provisions of the Act operate. The triggering condition is that a receiving order or assignment under the BIA be made against or by the lessee. Section 1 describes the effect of a receiving order or assignment into bankruptcy. Section 2 operates "as soon as the receiving order or assignment is made", making it clear that the pre-condition is the receiving order or assignment.

15 The entire LRBA should be read as relying upon the operation and effect of a receiving order or assignment under the BIA. Sections 3 and 4 of the LRBA, which limit the landlord's debt, must be interpreted as requiring the condition precedent of a receiving order or assignment. Nothing in the wording of the LRBA suggests it applies in the absence of a receiving order or assignment into bankruptcy, and no receiving order or assignment is made while a company attempts to restructure under the CCAA.

Section 12 of the CCAA

16 The specific sub-clause at issue in this appeal is s. 12(2)(a)(iii), which appears under the heading "Determination of amount of claim". Omitting the irrelevant sub-clauses, it states:

> For the purposes of this Act, the amount represented by a claim of any secured or unsecured creditor shall be determined as follows: (a) the amount of an unsecured claim shall be the amount... (iii) in the case of any other company, proof of which might be made under the Bankruptcy and Insolvency Act, but if the amount so provable is not admitted by the company, the amount shall be determined by the court on summary application by the company or by the creditor.

17 It is the appellant's position that this sub-clause must be interpreted as mandating the importation of the BIA and LRBA to expressly calculate the amount provable. I reject that interpretation for the three reasons set out below.

Use of the Word "Might" Conveying Discretion

**18** The first basis for my disagreement stems from Parliament's use of the words "might be made" (in sub-clause iii) which per se confers flexibility. This is underscored and reinforced when contrasted with the imperative "has been made" specified in the other two sub-clauses, (i) and (ii). In my view, "might" should be understood as meaning "could", i.e., the claim may be capable of being proven under the BIA.

**19** This interpretation is consistent with a long line of unassailable authorities. In Algoma Steel Corp. v. Royal Bank of Canada (1992), 11 C.B.R. (3d) 11 (Ont. Gen. Div.), Farley J. held that the word "shall" in s. 12(2) which then stated that "the amount represented by a claim...shall be defined as follows..." should be interpreted as "may" when one appreciates that the debtor companies and all affected stakeholders are entitled to a broad and liberal interpretation of the jurisdiction of the court under the CCAA.

**20** Ten years later, the following statement by Houlden and Morawetz in 2003 Annotated Bankruptcy and Insolvency Act (Toronto: Carswell, 2002) at 1100 is analogous to the issue before us. Citing In re Parisian Cleaners and Laundry Ltd. v. Blondin (1938), 20 C.B.R. 452 (Que. C.A.), they stated: "The purpose of s. 12(2) [of the CCAA] is to provide a means of determining the amount of a claim, not to incorporate the provisions of the Bankruptcy and Insolvency Act as to what constitutes a preferred or unsecured claim.". (Emphasis added) The same proposition is also supported by Québec (Sous-ministre du revenu) v. Wynden Canada Inc. (1983), 47 C.B.R. (N.S.) 76 (Que. S.C.), and Quebec Steel Products (Industries) Ltd. v. James United Steel Ltd. (1969), 5 D.L.R. (3d) 374 (Ont. H.C.).

**21** In my view, the words "might be made under the BIA" should be understood to mean "could be made". In other words, the claim may be, but must not necessarily be, capable of being proven under the BIA.

Use of the Word "Determined" Conveying "Methodology"

**22** My second disagreement stems from my broader interpretation of the word "determined" as used in the opening sentence of s. 12(2). The interpretation urged upon us by the appellant is that "determined" should be interpreted as meaning "calculated". However, reference to the BIA indicates that use of the term has two meanings: it can mean either a "methodology" or a "calculation", i.e., a formula for calculating a specific amount.

**23** That "determination" is used to mean "methodology" is illustrated by the following example. Section s. 121(1) broadly defines "claims provable" and the subsequent sub-sections add more specificity. Section 121(2) states that the "determination" of whether contingent and unliquidated claims are provable claims and their valuation is in made accordance with s. 135. The term "determination" in s. 121(2) clearly refers to a methodology, since s. 135 does not provide a formula for calculation of the amount, but rather a methodology at s. 135(1.1):

> Claims provable
>
> 121. (1) All debts and liabilities, present or future, to which the bankrupt is subject on the day on which the bankrupt becomes bankrupt or to which the bankrupt may become subject before the bankrupt's discharge 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.
>
> Contingent and unliquidated claims

(2) The determination whether a contingent or unliquidated claim is a provable claim and the valuation of such a claim shall be made in accordance with section 135.

Determination of provable claims

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

**24** When Parliament directed that the claims of unsecured creditors are those that might be proven under the BIA, it did not refer to the quantification or calculation of the amount provable in bankruptcy. In my view, it was intended to define who is included in the scheme of the CCAA, so as to override conflicting common law definitions.

The Dilemma of Which Section of the BIA To Invoke to Calculate Quantum

**25** This interpretation is supported by my third area of disagreement with the appellant. Were one to adopt the appellant's interpretation of sub-clause (iii), i.e., that the amount of the claim must be calculated in accordance with the methodology for calculating such claims under the BIA/LRBA, the issue then raised is: should one apply the method set out in s. 65.2 or that in s. 136, both of which apply to landlords? Each method yields substantially different results.

**26** As a preface, and at the risk of stating the obvious, the BIA governs two types of debtors. Part III, titled "Proposals", is similar to the scheme and object of the CCAA, and is intended to govern those debtors who, with the support their creditors, have a reasonable hope of returning to financial viability. In contrast, Part II, titled "Receiving Orders and Assignments" and its companion section, Part V ("Administration of Estates") govern situations where the debtor has no hope of returning to financial viability, but rather, its assets are vested in a trustee for distribution among the debtors' creditors. These two discrete objects of the BIA are essential to the analysis that follows.

**27** For landlords, the direction in s. 12(1)(a)(iii) of the CCAA cannot be read as requiring the valuation of the amount of the claim as set out in the BIA because the BIA itself provides two different methods and amounts that may be applicable to landlords' claims.

**28** The first is s. 65.2 (in Part III, Proposals), which makes provisions for disclaiming commercial leases. If the disclaimer of the lease is in accordance with the requirements of the section, s. 65.2(4) sets out the amount the landlord may claim as follows:

Effects of disclaimer

(4) Where a lease is disclaimed under subsection (1),

(a) the landlord has no claim for accelerated rent;
(b) the proposal must indicate whether the landlord may file a proof of claim for the actual losses resulting from the disclaimer, or for an amount equal to the lesser of
(i) the aggregate of

(A) the rent provided for in the lease for the first year of the lease following the date on which the disclaimer becomes effective, and
(B) fifteen percent of the rent for the remainder of the term of the lease after

that year, and

(ii) three year's rent; and

(c) the landlord may file a proof of claim as indicated in the proposal.

**29** Section 65.2 limits a landlord's claim under a proposal and provides for a larger amount than when the debtor is the subject of a receiving order or assignment. This accords with authorities which suggest that proposals must offer creditors some better advantage than a bankruptcy: Re Pateman (1991), 5 C.B.R. (3d) 115 (Man. Q.B.), Re Sumner Co. (1984) Limited (1987), 64 C.B.R. (N.S.) 218, In Re Allen Theatres Ltd. (1922), 3 C.B.R. 145 (Ont. S.C.).

**30** Section 136 (in Part V) provides a scheme for the distribution of the assets of a bankrupt who is the subject of a receiving order or an assignment under Part II. Landlords are specifically provided for at s. 136(1)(f) as follows:

Priority of claims

136. (1) Subject to the rights of secured creditors, the proceeds realized from the property of a bankrupt shall be applied in priority of payment as follows:

...

(f) the landlord for arrears of rent for a period of three months immediately preceding the bankruptcy and accelerated rent for a period not exceeding three months following the bankruptcy if entitled thereto under the lease, but the total amount so payable shall not exceed the realization from the property on the premises under lease, and any payment made on account of accelerated rent shall be credited against the amount payable by the trustee for occupation rent;

**31** This is the section that the appellant urges upon us as being part of the unbreakable thread. In my view, nothing in the wording of s. 136 assists it's position. On the contrary, the limitation on the amount a landlord may claim in s. 136(f) appears under the heading "priority of claim". As appellant's counsel explained, there is a trade off, the amount which the landlord receives is reduced from the full amount which could be claimed under a lease and in return, the landlord receives a priority position when the proceeds of the bankrupt's property is paid out. Section 136 requires payment of the enumerated claims in full in the order specified before any other unsecured creditor receives payment.

**32** However, there is no scheme for priority payment of claims set out in the CCAA. Thus, the effect on the landlord, were this interpretation accepted, is to compromise the claim not once, but twice, without the benefit of any priority, as noted by the Chambers Judge.

**33** If s. 65.2 were to be applied, it assumes that the proposal provisions, Part III of the BIA, applies to CCAA and not Parts II and V, the bankruptcy provisions. Section 146 of the BIA which allows for the application of provincial law is also included in Part V and its provisions are in reference to s. 136 which sets out distribution in bankruptcy proceedings, not proposals.

**34** If s. 12(2)(a)(iii) of the CCAA requires calculation of an amount in accordance with the BIA, as submitted by the appellant, it would have to stipulate which of ss. 65.2 or 136 is applicable. It does not, providing further support that the BIA does not direct the calculation of the amount of a landlord's claim in a CCAA proceeding or that the CCAA requires s. 136 of the BIA be applied.

**35** During oral argument, the appellant sought to distinguish cases involving Ontario's provincial legislation which is not as restrictive as the Alberta LRBA. But the provincial legislation setting out the rights of landlords in bankruptcy proceedings is irrelevant if ss. 136 and 146 of the BIA do not apply to the CCAA.

**36** There are numerous cases dealing with landlords' claims that have treated the CCAA as an autonomous statute and did not look to s. 12 as directing the use of BIA provisions to determine the amount of the claim. Re Woodward's Limited (1993), 20 C.B.R. (3d) 74 (B.C.S.C.), is an example of the purposive approach taken by courts under the CCAA in dealing with creditors.

**37** Decisions in Re Agnew Group Inc. unreported February 4, 1994 (Ont. Gen. Div.), Sklar-Peppler Furniture Corporation v. Bank of Nova Scotia (1991), 86 D.L.R. (4th) 621 (Ont. Gen. Div.), Grafton-Fraser Inc. v. Canadian Imperial Bank of Commerce (1992), 90 D.L.R. (4th) 285 (Ont. Gen. Div.), and Ambro Enterprises Inc. (Re) (1993), 22 C.B.R. (3d) 80 (Ont. Gen. Div.), all treated landlord's claims very differently than the BIA and took a broad approach to the classification and quantification of landlords' claims to facilitate the object and purpose of the CCAA.

**38** The appellant was unable to cite any authority to compel us to a different conclusion. The appellant submits that the Court's decision in Luscar Ltd. v. Smoky River Coal Ltd., [1999] A.J. No. 954, 175 D.L.R. (4th) 703 at 727, determined that s. 12(2) provides that an amount of a claim must be that amount as provided for under the BIA. I disagree. The issue in Smoky River (supra) was whether a CCAA judge had the discretion to establish a procedure for resolving a dispute between parties who had agreed by contract to arbitrate their disputes. This required that the dispute fall within the jurisdiction of the CCAA. In other words, the plaintiffs in the dispute had to be considered "creditors" for the purpose of the CCAA. The court's focus was on s. 12(1) of the CCAA, not s. 12(2). This Court looked to the similar wording between the BIA and CCAA referring to "debt provable in bankruptcy" and "claim provable in bankruptcy" to conclude that the plaintiffs, who had a contingent and unliquidated claim, were creditors. Valuation of the amount was not an issue since the claim was contingent and unliquidated. The issue was solely one of the court's discretion to establish a process to resolve the amount of the claim.

**39** The wording in s. 12(2)(a)(iii) is intended to be and must be general. That sub-clause captures all the unsecured claims of a company not subject to a receiving order or assignment or winding up. These unsecured claims include landlords as creditors, but also capture a host of unliquidated and contingent claims, the latter of which would not be defined as creditors at common law. Thus, the phrase "proof of which might be made under the Bankruptcy and Insolvency Act" directs that the various methods within the BIA to determine claims are to be employed to cover the wide range of potential claims. This clause is intended to define who is included in the scheme of the CCAA and override conflicting common law definitions.

**40** Moreover, amendments to both the BIA and CCAA in 1997 and 1998 were intended to harmonize the two pieces of legislation. Changes were made to the BIA to enhance the rights given to landlords, but no change in either legislation amended or introduced provisions to apply the BIA to landlords in CCAA proceedings.

**41** More recently, in November 2003, the Standing Senate Committee on Banking, Trade and Commerce released "Debtors and Creditors Sharing the Burden: A Review of the BIA and the CCAA", a report calling for substantial reform of the federal insolvency statutes (the "Report"). Twenty-two of the Committee's recommendations apply specifically to commercial insolvencies.

**42** A very broad range of stakeholders provided input on virtually all elements of the two Acts. The

Committee concluded that [p. 173]: "We believe that the need for flexibility is paramount with the CCAA....". As a consequence, they recommend that the BIA and the CCAA continue to operate as separate statutes.

**43** The Report also considered the existence of contracts, including leases, and how these should be dealt with under the legislation. The Joint Task Force on Business Insolvency Law Reform was of the view that the ability set out in the BIA to disclaim executory contracts including real property leases should apply to all bankruptcy and insolvency proceedings. The Committee's final recommendation was that:

> The BIA and the CCAA be amended to permit disclaimer of executory contracts in existence in the date of commencement of proceedings under the Acts. This disclaimer should apply to all contracts, provided that a number of conditions are met. In particular: the debtor should be obliged to establish inability or serious hardship in restructuring the enterprise without the disclaimer; the co-contracting party should be permitted to file a claim in damages in the restructuring [and other conditions specific to collective agreements].

[Emphasis added]

**44** The Report recognized that the CCAA treats landlords differently than the BIA and harmonization in respect of this difference was recommended. Significantly, no such recommendations were made with respect to implementing a consistent approach for the valuation of a landlord's claim.

Purposes of the BIA and CCAA

**45** Assuming the words are capable of bearing the interpretation urged upon us by the appellant, statutory interpretation requires that s. 12 be read in the context of the scheme, the object, and the intention of Parliament in passing the CCAA and where the CCAA refers to the BIA, regard must also be given to the scheme, object and intention of that Act.

**46** The proper approach to statutory interpretation requires that words be read contextually to give effect to the purpose and intent of the legislation. As the Supreme Court of Canada recently stated in Harvard College v. Canada (Commissioner of Patents), [2002] 4 S.C.R. 45 at para. 154, "This Court has on many occasions expressed the view that statutory interpretation cannot be based on the wording of the legislation alone (Rizzo & Rizzo Shoes Ltd. (Re), [1998] 1 S.C.R. 27)". When interpreting specific provisions, a court must pay sufficient attention to the scheme of an act, its objects or the intention of the legislature.

**47** The BIA is a comprehensive legislative scheme largely designed to facilitate the orderly liquidation of the estate of a bankrupt. The purposes of the Act include conducting the liquidation in a manner that maximizes recovery for the general benefit of the creditors, treating similarly situated creditors fairly and in accordance with the Act. The Act sets out priorities and a detailed process, making the BIA a logical choice when the only possible outcome is dissolution. It provides a high degree of certainty for all creditors.

**48** The CCAA is a very brief piece of legislation with a purpose described in Elan Corp. v. Comiskey (1990), 1 O.R. (3d) 289 (C.A.) as follows:

> The legislation is remedial in the purest sense in that it provides a means whereby

devastating, social and economic effects of bankruptcy or creditor-initiated detriments of ongoing business operations can be avoided while court-supervised attempt to reorganize the financial affairs of the debtor is made.

**49** The very brevity of the Act and the fact that it is silent on details permits a wide and liberal construction to enable the Act to serve its remedial purpose: Chef Ready Foods Ltd. v. Hongkong Bank of Canada, [1991] 2 W.W.R. 136 (B.C.C.A.).

**50** The role of the CCAA is unique. It affords the debtor company an opportunity to restructure its affairs in a manner that will permit it to continue as a going concern without intervention by creditors which might hamper or prevent the restructuring process. Its ultimate goal is to avoid bankruptcy, thereby maximizing creditor compensation, reducing the inevitable loss of employment precipitated by bankruptcy and, if successful, offering the prospect of shareholder equity. The debtor remains in possession and control of the company under the supervision of a court appointed monitor. See for example, Re Canadian Airlines Corp., [2000] 10 W.W.R. 269, [2000] A.J. No. 771, 2000 ABQB 442, leave denied, [2000] 10 W.W.R. 314, [2000] A.J. No. 1028, 2000 ABCA 238, leave denied [2001] S.C.C.A. No. 60; Re Lehndorff General Partner Ltd. (1993), 17 C.B.R. (3d) 24 (Ont. Gen. Div.); Northland Properties Ltd. v. Excelsior Life Insurance Co. of Canada, [1989] 3 W.W.R. 363 (B.C.C.A.).

**51** The decision to seek protection under the CCAA is that of the debtor. There are numerous considerations in choosing the CCAA as opposed to utilizing the proposal provisions of the BIA, however, one significant factor is the high degree of flexibility the CCAA offers in terms of plan fundamentals and process. The BIA is highly rule driven with clearly defined standards and processes for developing a proposal. Thus, the debtor company under CCAA has far broader latitude within which to propose a plan capable of winning creditor support.

**52** A company which invokes the CCAA process retains a great deal of control over it. Under the CCAA claims process, the company, not the monitor, initially accepts or rejects claims. Section 12(2)(a)(iii) states, "if the amount so provable is not admitted by the company, the amount shall be determined by the court on summary application by the company or by the creditor".

**53** Section 12(2)(a)(iii) permits different treatment of different claims. The company can admit a claim, or refer it to a court to determine by summary application or trial. In recent cases, recognizing the need for expedited valuation of claims to facilitate the process, the courts have begun appointing a claims officer to make this determination.

**54** Rehabilitation of a company under the CCAA is furthered by a climate that allows for commercial realities and variables to be considered and negotiated among and by the affected parties. The debtor company, through the operation of the stay, is given the breathing room to explore alternatives and to structure a proposed plan that will find favour with creditors, sufficient to support the restructuring.

**55** To maximize flexibility, it is unwise and unnecessary to incorporate, by oblique reference, portions of the BIA or the LRBA that may not assist the process. What the CCAA requires is that the end result, the plan of arrangement, be fair and reasonable. Only when those conditions are met, will a plan of arrangement be approved by a court. What constitutes fairness is largely determined by the circumstances of each case. An important measure of fairness is the degree to which creditors approve it. Creditor support can create an inference that assenting creditors see the plan as viable and commercially reasonable given other available alternatives. The courts generally accept the view that the creditors are in a better position to determine whether the plan is in their own best interests.

The implications of incorporating all BIA provisions into the CCAA

**56** If the appellant's interpretation of s. 12 of the CCAA is accepted, such an interpretation would not be limited to claims by landlords but would include all other unsecured creditors who fall within the provisions of the BIA. At minimum, tax claimants, employees claims, and workers compensation indebtedness as provided in s. 136 of the BIA would apply to the CCAA, thereby increasing the rigidity and reducing the options for compromise.

**57** Under the BIA, the claims receiving priority after secured creditors are enumerated in s. 136 and have ten categories, each ranking behind the other. All must be paid in full before unsecured creditors recover anything. If the appellant is correct, arguably, those claims must be quantified under the BIA but without priority and subject to possible further compromise.

**58** Two other examples illustrate the uncertainty and difficulty that would arise if the appellant's submission was adopted. First, federal excise tax legislation gives Canada Customs and Revenue Agency (CCRA) a deemed trust for amounts due to it for GST and prohibits any legislation other than the BIA from overriding the deemed trust. There is no deemed trust in a bankruptcy, but cases have held a deemed trust exists in a CCAA restructuring: see Gauntlet Energy [2003] A.J. No. 1504 (ABQB). If the appellant is correct, then excise tax claims must be treated the same in CCAA and a deemed trust would be overridden.

**59** A second example that would import complex and unsettled issues in bankruptcy law is a severance claim. These claims raise thorny issues such as whether the bankruptcy itself triggers termination of employment without cause and thereby gives rise to a provable claim, whether legislation which continues a collective agreement gives rise to a severance claim, and whether a bankruptcy triggered by a creditor and not the bankrupt is to be distinguished. Under the CCAA, employees' claims for severance avoid those issues by treating employees as claimants and capable of being compromised under the CCAA. In Re Woodward's Ltd., a British Columbia case, the court recognized the claims of employees who were terminated and included them in the class of general creditors maintaining that once the amount of the claim had been agreed upon or determined by a court, the employees had the same rights as any other unsecured creditor.

The inconsistency of the BIA and LRBA with the objectives of the CCAA

**60** Automatically applying the LRBA when protection is sought under the CCAA results in the immediate compromise of a landlord's claim prior to the formulation of a plan. Its effect could be to isolate the landlord's claim, treating it differently and potentially unfairly by automatically compromising it without consideration of the plan as a whole. There is no compelling reason for such an a priori blanket regime for landlords in a CCAA proceeding that is intended to preserve the status quo pending the approval of a plan.

**61** There is no reported decision of a court applying s. 136 of the BIA, the LRBA or other provincial legislation equivalent to the LRBA. Instead, case law shows those provisions are not applied and courts have agreed with Farley J., who stated in Re Lehndorff General Partner Ltd. at para. 11, "Amounts owing to landlords in respect of arrears of rent or unpaid rent for the unexpired portion of lease terms are properly dealt with in a plan of compromise or arrangement: see Sklar-Peppler Furniture Corporation (1992), 8 C.B.R. (3d) 312 (Ont. Gen. Div.) especially at p. 318."

**62** Landlords' claims have been a source of difficulty under the CCAA and have spawned considerable academic comment on the problems and potential ways to resolve them. The chambers judge and the respondent have noted many including the following: Moffat, "Treatment of Landlords in Commercial Re-organizations" (1997) 10 Comm. Insol. R. 14; Rotsztain and Kraft, "Landlords and Leases in Bankruptcy and Insolvency Act and Companies' Creditors Arrangement Act

Reorganizations" [1994] ICR 2005; Marantz, "Retail Revival: The Eaton's Restructuring" (1998), 10 Comm. Insol. R. 37; Birkness, "Re Woodward's Limited - The Contextual Commonality of Interest Approach to Classification of Creditors" (1993) 20 C.B.R. (3d) 91; Kulidjian, Sheldon and Peck, "Potential Creditors Under the Companies' Creditors Arrangement Act" (1996) 13 National I. R. 4; Marantz, "Dealing with Proposals: Acting for the Creditor in CCAA and the New Bankruptcy Act Proposals" (Ontario: Canadian Bar Association C.L.E., 1993); Hayes, "Landlords' Rights on Bankruptcy and in Restructuring Proceedings" in The Failing Smaller Business: Essential Debtor - Creditor Practice (Law Society of Upper Canada, 1994); and Johnston and Campbell, "Using the CCAA to Cram Down' Landlords: Sklar-Pepplar Furniture Corporation v. Bank of Nova Scotia and its Aftermath" (1992) 1 Nat. Real Property L. Rev. (2d) 181.

**63** Much of the comment accords with those of Moffat, "Treatment of Landlords in Commercial Reorganizations", where the author states at 16:

> Unlike the proposal provisions of Part II of the BIA, the CCAA does not make any special provision for the valuation or classification of landlord claims under a plan. This does not give the debtor the power to compromise a landlord's claim in any way it chooses; the courts have placed limits on the method by which landlord claims may be valued and classified under a plan. A landlord which objects to its treatment under a plan may pursue a number of remedies, including seeking amendment of the plan prior to the meeting of creditors held to vote upon the plan, voting against the plan at the creditors' meeting, and opposing court approval of the plan at the sanction hearing.

**64** Courts have approved a variety of solutions to quantifying landlord's claims without reliance on the BIA or provincial legislation. In Sklar-Peppler Furniture Corporation v. Bank of Nova Scotia, the court classified the landlords among the general class of unsecured creditors for both outstanding rent and any contingent claim for damages arising from repudiation of the lease. The court permitted the termination of certain leases upon the plan's approval and limited damages to three months arrears of rent, three months' rent after a protection order and share pro rata with other ordinary creditors for the balance of their claims. Borins J. stated at 318:

> [R]ecognition must be given to the legislative intent to facilitate corporate reorganization and that in the modern world of large and complex business enterprises the excessive fragmentation of classes could be counter-productive to the fulfilment of this intent....In my view, in placing a broad and purposive interpretation upon the provisions of the CCAA the court should take care to resist approaches which would potentially fragment creditors and thereby jeopardize potentially viable plans of arrangement, such as the plan advance in this application.

**65** In Grafton Fraser and in Re Agnew Group Inc., the landlords were granted claims based on the present value of the unexpired terms of the abandoned leases. In Agnew, with the exception of one landlord with a particularly long term lease, landlords received a maximum of six months' rent.

**66** Rotsztain and Kraft in "Landlords and Leases in BIA and CCAA Reorganizations" commenting on Agnew and Grafton-Fraser note at 5-31 that, "A claim based on the present value of the unexpired term of the lease is something which landlords generally look upon more favourably than a straight payment of a few months' rent." The authors explain that this is because this approach recognizes the significant long term impact termination can have on landlords and allows the factoring in of tenant inducements which are generally built into rental payments over the entire lease.

**67** On this appeal, the appellant suggests incorporating the LRBA serves a useful purpose because without the LRBA limitations, the landlord's claim is so potentially large that it makes a restructuring impossible, and requires too much time to mitigate and thus to quantify the landlord's claim.

**68** Speaking generally, I disagree that the magnitude or quantification issues arising from a landlord's claim make restructuring impossible. Treatment of a landlord's claim under a plan may produce the same result as that under the LRBA and such plan might be approved by both the landlord and the court. Similarly, treatment under the plan could be less than or more than the amount provided for under the LRBA. But these are issues for negotiation and ultimately, court approval.

**69** In the absence of legislation, the unique and distinct purpose of the CCAA has been and must remain the focus for judicial interpretation and discretion. Where there is neither statutory direction nor demonstrated need, it is undesirable to import statutory provisions that may have a negative affect on the flexibility afforded by the CCAA and thus become an impediment to its creative use. Adopting the LRBA as determinative of a landlord's claim under the CCAA is an example of narrowing the benefit of a broad statute in favour of a certainty. As a general proposition and without considering the merits of that position in a particular plan, such an approach is to be discouraged.

Relief

**70** For these reasons, the appeal is dismissed.

PAPERNY J.A.
MCFADYEN J.A.:-- I concur.
CLARK J. (ad hoc):-- I concur.

* * * * *

CORRIGENDUM
Released: April 13, 2004.

A change has been made to paragraph [58] of this judgment.

Paragraph [58] originally read:

[58] Two other examples illustrate the uncertainty and difficulty that would arise if the appellant's submission was adopted. First, federal excise tax legislation gives Canada Customs and Revenue Agency (CCRA) a deemed trust for amounts due to it for GST and prohibits any legislation other than the BIA from overriding the deemed trust. There is no deemed trust in a bankruptcy, but cases including this proceeding have held a deemed trust in a CCA restructuring If the appellant is correct, then excise tax claims must be treated the same in CCAA and a deemed trust would be overridden.

and has been corrected to read:

[58] Two other examples illustrate the uncertainty and difficulty that would arise if the appellant's submission was adopted. First, federal excise tax legislation gives Canada Customs and Revenue Agency (CCRA) a deemed trust for amounts due to it for GST and prohibits any legislation other than the BIA from overriding the deemed trust. There is no deemed trust in a bankruptcy, but cases have held a deemed trust exists in a CCAA restructuring: see Gauntlet Energy [2003] A.J. No. 1504 (ABQB). If the appellant is correct, then excise tax claims must be treated the same in CCAA and a deemed trust would be overridden.

Please replace this page in your hard copy of the judgment.

cp/e/qw/qlmmm/qlcas/qlmjb

# TAB 3

*Case Name:*

**Nelson Financial Group Ltd. (Re)**

**IN THE MATTER OF the Companies' Creditors Arrangement Act, R.S.C. 1985, C-36, as amended AND IN THE MATTER OF a Plan of Compromise or Arrangement of Nelson Financial Group Ltd.**

[2010] O.J. No. 4903

**2010 ONSC 6229**

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

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

2010 CarswellOnt 8655

Court File No. 10-8630-00CL

Ontario Superior Court of Justice
Commercial List

**S.E. Pepall J.**

November 16, 2010.

(36 paras.)

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

Motion by the holders of promissory notes from the debtor company for an order that all claims and

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

HELD: Motion allowed. The preferred shareholders were shareholders of the company, not creditors. The substance of the arrangement between the preferred shareholders and the company was a relationship based on equity and not debt. The claims of the preferred shareholder in the present case did not constitute a claim provable for the purposes of the Companies' Creditors Arrangement Act. The language of s. 2 of the Act was clear and unambiguous and equity claims included a claim in respect of an equity interest and a claim for a dividend or similar payment and a claim for rescission. This encompassed the claims of all of the preferred shareholders.

**Statutes, Regulations and Rules Cited:**

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

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

**Counsel:**

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

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

Pamela Foy, for the Ontario Securities Commission.

Frank Lamie, for Nelson Financial Group Ltd.

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

Michael Beardsley, Self Represented Respondent.

Clifford Holland, Self Represented Respondent.

Arnold Bolliger, Self Represented Respondent.

John McVey, Self Represented Respondent.

Joan Frederick, Self Represented Respondent.

Rakesh Sharma, Self Represented Respondent.

Larry Debono, Self Represented Respondent.

Keith McClear, Self Represented Respondent.

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## REASONS FOR DECISION

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

Background Facts

2 Nelson was incorporated pursuant to the *Business Corporations Act* of Ontario in September, 1990. Nelson raised money from investors and then used those funds to extend credit to customers in vendor assisted financing programmes. It raised money in two ways. It issued promissory notes bearing a rate of return of 12% per annum and also issued preference shares typically with an annual dividend of 10%.[1] The funds were then lent out at significantly higher rates of interest.

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

(a) Noteholders

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

(b) Preferred Shareholders

5 Nelson was authorized to issue two classes of common shares and 2,800,000 Series A preferred shares and 2,000,000 Series B preferred shares, each with a stated capital of $25.00. The president and sole director of Nelson, Marc Boutet, is the owner of all of the issued and outstanding common shares. By July 31, 2007, Nelson had issued to investors 176,675 Series A preferred shares for an

aggregate consideration of $4,416,925. During the subsequent fiscal year ended July 31, 2008, Nelson issued a further 172,545 Series A preferred shares and 27,080 Series B preferred shares. These shares were issued for an aggregate consideration of $4,672,383 net of share issue costs.

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

**7** As of the *CCAA* filing date of March 23, 2010, Nelson had issued and outstanding 585,916.6 Series A and Series B preferred shares with an aggregate stated capital of $14,647,914. The preferred shares are held by approximately 82 people. As of the date of filing of these *CCAA* proceedings, there were approximately $53,632 of declared but unpaid dividends outstanding with respect to the preferred shares and $73,652.51 of accumulated dividends.

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

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

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

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

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

(c) Insolvency

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

(d) Ontario Securities Commission

**13** On May 12, 2010, the Ontario Securities Commission ("OSC") issued a Notice of Hearing and Statement of Allegations alleging that Nelson and its affiliate, Nelson Investment Group Ltd., and various officers and directors of those corporations committed breaches of the *Ontario Securities Act* in the course of selling preferred shares. The allegations include non-compliance with the prospectus requirements, the sale of shares in reliance upon exemptions that were inapplicable, the sale of shares to persons who were not accredited investors, and fraudulent and negligent misrepresentations made in the course of the sale of shares. The OSC hearing has been scheduled for the end of February, 2011.

(e) Legal Opinion

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

(f) Development of Plan

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

Motion

**16** The holders of promissory notes are represented by Representative Counsel appointed

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

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

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

**19** Mr. Styles states that he and his company invested approximately $4.5 million in Nelson. He states that Mr. Boutet persuaded him to convert his promissory notes into preference shares by promising a 13.75% dividend rate, assuring him that the obligation of Nelson to repay would be treated the same or better than the promissory notes, and that they would have the same or a priority position to the promissory notes. He then received dividends at the 13.75% rate contrary to the 10% rate found in the company's articles. In addition, at the time of the conversion, Nelson was insolvent.

**20** In brief, Mr. Styles submits that:

(a) the investment transactions were void because there was no prospectus contrary to the provisions of the *Securities Act* and the Styles were not accredited investors; the preferred shares were issued contrary to section 23(3) of the *OBCA* in that Nelson was insolvent at the relevant time and as such, the issuance was a nullity; and the conduct of the company and its

principal was oppressive contrary to section 248 of the *OBCA*; and that
(b) the Styles' claim is in respect of an undisputed agreement relating to the conversion of their promissory notes into preferred shares which agreement is enforceable separate and apart from any claim relating to the preferred shares.

The Issue

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

The Law

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

Section 2 of the *CCAA* states:

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

corporation -- or a warrant or option or another right to acquire a share in the corporation -- other than one that is derived from a convertible debt, and

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

Section 6(8) states:

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

Section 22.1 states:

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

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

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

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

**25** Historically, the claims and rights of shareholders were not treated as provable claims and ranked after creditors of an insolvent corporation in a liquidation. As noted by Laskin J.A. in *Re Central Capital Corporation*[2], on the insolvency of a company, the claims of creditors have always ranked ahead of the claims of shareholders for the return of their capital. This principle is premised on the notion that shareholders are understood to be higher risk participants who have chosen to tie their investment to the fortunes of the corporation. In contrast, creditors choose a lower level of exposure, the assumption being that they will rank ahead of shareholders in an insolvency. Put differently, amongst other things, equity investors bear the risk relating to the integrity and character of management.

26 This treatment also has been held to encompass fraudulent misrepresentation claims advanced by a shareholder seeking to recover his investment: *Re Blue Range Resource Corp.*[3] In that case, Romaine J. held that the alleged loss derived from and was inextricably intertwined with the shareholder interest. Similarly, in the United States, the Second Circuit Court of Appeal in *Re Stirling Homex Corp.*[4] concluded that shareholders, including those who had allegedly been defrauded, were subordinate to the general creditors when the company was insolvent. The Court stated that "the real party against which [the shareholders] are seeking relief is the body of general creditors of their corporation. Whatever relief may be granted to them in this case will reduce the percentage which the general creditors will ultimately realize upon their claims." *National Bank of Canada v. Merit Energy Ltd.*[5] and *Earthfirst Canada Inc.*[6] both treated claims relating to agreements that were collateral to equity claims as equity claims. These cases dealt with separate indemnification agreements and the issuance of flow through shares. The separate agreements and the ensuing claims were treated as part of one integrated transaction in respect of an equity interest. The case law has also recognized the complications and delay that would ensue if *CCAA* proceedings were mired in shareholder claims.

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

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

29 Guidance on the appropriate approach to the issue of characterization was provided by the Ontario Court of Appeal in *Re Central Capital Corporation*[7]. Central Capital was insolvent and sought protection pursuant to the provisions of the *CCAA*. The appellants held preferred shares of Central Capital. The shares each contained a right of retraction, that is, a right to require Central Capital to redeem the shares on a fixed date and for a fixed price. One shareholder exercised his right of retraction and the other shareholder did not but both filed proofs of claim in the *CCAA* proceedings. In considering whether the two shareholders had provable debt claims, Laskin J.A. considered the substance of the relationship between the company and the shareholders. If the governing instrument contained features of both debt and equity, that is, it was hybrid in character, the court must determine the substance of the relationship between the company and the holder of the certificate. The Court examined the parties' intentions.

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

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

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

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

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

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

**32** The substance of the arrangement between the preferred shareholders and Nelson was a relationship based on equity and not debt. Having said that, as I observed in *I. Waxman & Sons.*[8], there is support in the case law for the proposition that equity may become debt. For instance, in that case, I held that a judgment obtained at the suit of a shareholder constituted debt. An analysis of the nature of the claims is therefore required. If the claims fall within the parameters of section 2 of the *CCAA*, clearly they are to be treated as equity claims and not as debt claims.

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

(a) declared but unpaid dividends;

(b) unperformed requests for redemption;

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

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

**34** In my view, all of these claims fall within the ambit of section 2, are governed by sections 6(8) and 22.1 of the *CCAA*, and therefore do not constitute a claim provable for the purposes of the statute. The language of section 2 is clear and unambiguous and equity claims include "a claim that is in respect of an equity interest" and a claim for a dividend or similar payment and a claim for rescission. This encompasses the claims of all of the preferred shareholders including the Styles

whose claim largely amounts to a request for rescission or is in respect of an equity interest. The case of *National Bank of Canada v. Merit Energy Ltd.*[9] is applicable in regard to the latter. In substance, the Styles' claim is for an equity obligation. At a minimum, it is a claim in respect of an equity interest as described in section 2 of the CCAA. Parliament's intention is clear and the types of claims advanced in this case by the preferred shareholders are captured by the language of the amended statute. While some, and most notably Professor Janis Sarra[10], advocated a statutory amendment that provided for some judicial flexibility in cases involving damages arising from egregious conduct on the part of a debtor corporation and its officers, Parliament opted not to include such a provision. Sections 6(8) and 22.1 allow for little if any flexibility. That said, they do provide for greater certainty in the appropriate treatment to be accorded equity claims.

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

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

S.E. PEPALL J.

cp/e/qlafr/qlvxw/qlana

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

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

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

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

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

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

7 Supra, note 2.

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

9 Supra, note 5.

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

# TAB 4

*Case Name:*
**Royal Bank of Canada v. Central Capital Corp.**

**RE: Royal Bank of Canada et al., and Central Capital Corporation**

[1996] O.J. No. 359

27 O.R. (3d) 494

132 D.L.R. (4th) 223

88 O.A.C. 161

26 B.L.R. (2d) 88

38 C.B.R. (3d) 1

61 A.C.W.S. (3d) 18

Nos. C21479 and C21477

Ontario Court of Appeal
Toronto, Ontario

**Finlayson, Weiler and Laskin JJ.A.**

February 7, 1996.

(154 paras.)

**Counsel:**

Bryan Finlay, Q.C., and John M. Buhlman, for appellants, James W. McCutcheon and Central Guaranty Trust.

James H. Grout and Anne Sonnen, for appellant, Consolidated S.Y.H. Corp.

Terrence J. O'Sullivan and Paul G. Macdonald, for the unsecured creditors of Central Capital Corp.

Neil C. Saxe, for Peat Marwick Thorne Inc.

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Raesons for judgment were delivered by Finlayson J.A., concurred in by Weiler J.A. Separate

reasons were delivered by Laskin JJ.A.

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

Overview of the Proceedings

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

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

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

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

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

creditors of Central Capital who elected to exchange a portion of the indebtedness from Central Capital for shares and debentures to be issued by CIGL as aforesaid; and

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

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

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

Issue

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

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

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

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

Overview of the Restructuring of Central Capital

**9** The order of Houlden J. of July 9, 1992 directed the restructuring of Central Capital under the aegis of the court. The order, and others that would follow, contemplated that the restructuring would take place in two stages. The first stage involved the transfer to the Administrator of certain major assets of Central Capital to a company to be incorporated called Central Insurance Group Limited (CIGL). This

company is frequently referred to in the documentation and the reasons of Feldman J. as "Newco". CIGL was then to be owned by those Central Capital creditors who chose to participate in the reorganization by accepting a reduction in their debts due from Central Capital and exchanging this reduced indebtedness for debentures in CIGL. Subscription for debentures by this means additionally entitled the creditors to subscribe for shares in CIGL. Our understanding from counsel is that the assets transferred to CIGL included the assets acquired by Central Capital from the appellants in purchase agreements described later in these reasons.

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

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

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

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

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

Facts as they Relate to the Claim of McCutcheon

**15** By a share purchase agreement dated June 15, 1987 between Central Capital and Gormley Investments Limited ("Gormley") and Heathley Investments Limited ("Heathley"), Central Capital agreed to purchase all Class "B" voting shares of Canadian General Securities Limited ("CGS") that were owned by Gormley and Heathley. James W. McCutcheon and his brother, who were the sole

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

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

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

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

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

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

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

**22** Article 7 of the Series Senior B Provisions provides that in the event of the liquidation, dissolution or winding-up of Central Capital, whether voluntary or involuntary, or any other distribution of assets of

Central Capital among its shareholders for the purposes of winding up its affairs, the holders of the Series B Senior Preferred Shares shall be entitled to receive, from the assets of Cental Capital, $25 per Series B Senior Preferred Shares, plus all accrued and unpaid dividends thereon, to be paid prior to payment to junior ranking shareholders. Upon payment of such amounts, the holders of the Series B Senior Preferred Shares shall not be entitled to share in any further distribution of assets of Central Capital.

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

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

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

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

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

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

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

Facts as they Relate to the Claim of SYH

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

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

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

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

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

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

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

Analysis

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

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

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

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

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

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

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

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

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

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

something; the being under such liability.

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

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

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

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

**39** The rules relating to the competing rights of shareholders and creditors of an insolvent corporation have become so regulated by governmental action that one can readily lose sight of the common law basis for making a distinction. To understand the difference in treatment, we must re-examine what a share of a corporation represents. Initially, a share is issued by the corporation to raise share capital. The price of the share is money or the promise of money. Accordingly, an individual share is one of a

number of separate but integral parts of the authorized capital of a corporation. Even though it is the shareholders who contribute to the capital of the corporation, the capital remains the property of the corporation. The shareholders, however, as owners of the shares of capital, effectively control the corporation. They have the responsibility of managing its affairs through their control over the board of directors and in popular terminology are considered to be the owners of the corporation. However, the corporation is a separate entity in law, and if in the course of carrying out its business it incurs debts to third parties, those debts are those of the corporation. A corporation is an intangible and its capital therefore represents its substance to third parties having business dealings with the corporation. A preferred share is simply a share of a class of issued shares which contains a preference over other classes of shares, whether preferred or common: see Sutherland, Fraser and Stewart on Company Law of Canada, 6th ed. (1993), at pp. 157 and 195 for further discussion.

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

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

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

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

**42** Creditors, on the other hand, do not have an ownership or equity interest in the corporation. They are third parties who have loaned money or otherwise advanced credit to the corporation. They look to the company for payment in accordance with the terms of the contract creating the indebtedness. They are also restricted in their recovery to the amounts stipulated in the terms of indebtedness. They are entitled to payment regardless of the financial circumstances of the debtor corporation and accordingly are not restricted to receiving payment of the debt from surplus. They can be paid out of assets or through the creation of further indebtedness. It is immaterial how the corporation records this indebtedness in its internal books. In some circumstances the indebtedness could properly reflect the

acquisition of property from a creditor as a capital asset. This does not, however, convert the creditor into an investor. The vendor of the property remains a creditor and retains priority over shareholders in the event of a bankruptcy or insolvency.

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

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

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

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

> As I see it, the fact that the transaction contains both debt and equity features does not, in itself, pose an insurmountable obstacle to characterizing the advance of $255 million. Instead of trying to pigeonhole the entire agreement between the Participants and CCB in one of two categories, I see nothing wrong in recognizing the arrangement for what it is, namely, one of a hybrid nature, combining elements of both debt and equity but which, in substance, reflects a debtor-creditor relationship. Financial and capital markets have been most creative in the variety of investments and securities that have been fashioned to meet the needs and interests of those who participate in those markets. It is not because an agreement has certain equity features that a court must either ignore these features as if they did not exist or characterize the transaction on the whole as an investment. There is an alternative. It is permissible,

> and often required, or desirable, for debt and equity to co-exist in a given financial transaction without altering the substance of the agreement. Furthermore, it does not follow that each and every aspect of such an agreement must be given the exact same weight when addressing a characterization issue. Again, it is not because there are equity features that it is necessarily an investment in capital. This is particularly true when, as here, the equity features are nothing more than supplementary to and not definitive of the essence of the transaction. When a court is searching for the substance of a particular transaction, it should not too easily be distracted by aspects which are, in reality, only incidental or secondary in nature to the main thrust of the agreement.

(Emphasis in original)

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

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

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

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

> I shall use Mr. Neels [a co-operative member] as my example. According to R.

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

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

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

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

**53** There was no evidence led as to why this provision was placed in the articles and the share certificates. It appears to be a standard clause in all the preference shares issued by the corporation and not just those that were adapted to the appellants' situations where specific retraction clauses were drafted to satisfy the particular asset acquisitions. For my part, I have difficulty in understanding how a consideration of this provision assists the process of determining the underlying character of the

retraction obligations. The statement is so self-evident that it is almost banal. I can only assume that the statement was included in the share provisions of a corporation marketing its securities world-wide so as to inform purchasers that legal restrictions in this jurisdiction apply to the company's right to redeem shares.

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

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

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

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

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

reorganization of Central Capital.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

**71** James McCutcheon and his brother sold their shares in Central Guarantee Trust Company to Central Capital Corporation ("Central Capital"), a trust company, for $575 a share. They received $400

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

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

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

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

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

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

1. Was Feldman J. correct in characterizing the agreement between Central

Capital and the companies owned by McCutcheon, and between Central Capital and SYH, as creating a shareholder relationship between the parties?

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

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

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

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

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

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

**82** The appellants argue that Feldman J. erred in this conclusion. They submit that although McCutcheon and SYH may have been shareholders initially, this relationship changed. Upon McCutcheon's exercise of his right to have the corporation pay him the retraction price of his shares, he ceased to be a shareholder. When Central Capital failed to pay him, he became a creditor of the

corporation. In the case of SYH, it is submitted that when the lenders opted to reorganize the company, they, in effect, triggered the obligation to redeem SYH's shares.

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

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

(b) Section 36 of the CBCA

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

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

(Emphasis added)

**85** There is no dispute that Central Capital was unable to redeem McCutcheon's shares on the retraction date. Nor could it redeem SYH's shares on the date of the reorganization. The appellants agree that the effect of s. 36 renders the agreement between themselves and Central Capital unenforceable. It is the position of the appellants, however, that s. 36 does not extinguish a debt or liability which they say has been created. The appellants rely on the decision in Re East Chilliwack Agricultural Co-operative

(1989), 74 C.B.R. (N.S.) 1, 58 D.L.R. (4th) 11 (B.C.C.A.), in support of their position that a debt or liability is created notwithstanding the solvency requirements of s. 36 respecting payment. The appellants' submission does not take into consideration the major differences between the decision in East Chilliwack and the present situation relating to the timing, effect of the solvency requirements and the provisions in the articles governing the relationship of the parties.

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

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

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

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

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

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

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

creditor.

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

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

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

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

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

**97** Looked at another way, after the retraction date and at the time of the reorganization, the common features of a debtor-creditor relationship are not in evidence in Central Capital's articles. The agreements between the parties contain no express provision that the redemption of the shares is in repayment of a loan. The corporation was not obliged to create any fund or debt instrument to ensure that it could redeem the shares on the retraction date. There is no indemnity in the event that the money is not repaid on the retraction date. There is no provision for the payment of any interest after the retraction date in the event that the money is not repaid on the retraction date. There is no provision that after the retraction date and in the event of insolvency, the appellants would have the right to have the company wound up. (See R. v. Imperial General Properties Ltd., [1985] 2 S.C.R. 288, 21 D.L.R. (4th) 741, for a

case where the articles of the company contained this right.) There is no provision that upon a winding-up or insolvency the parties are entitled to rank pari passu with the creditors as was the case in Canada Deposit Insurance Corp. v. Canadian Commercial Bank, supra.

(d) The effect of the reorganization

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

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

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

Dividends

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

**102** Article 7 of Central Capital respecting McCutcheon's shares states that in the event of a liquidation, dissolution or winding-up of the corporation, the shareholders are entitled to receive not

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

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

**104** Section 42 of the CBCA provides:

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

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

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

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

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

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

The Meaning of Debt

**109** Debt is defined in a very broad manner in Black's Law Dictionary, 6th ed. (1990) at p. 403. It is the position of the appellants that this definition of "debt" is broad enough to include McCutcheon's right to have Central Capital redeem his shares. In the case of SYH, it is submitted that the right to redemption constitutes a future liability. It is the appellants' position that Feldman J. erred in holding that

to have a provable claim, McCutcheon and Central Capital must be able to obtain a judgment against Central Capital for the retraction price and be entitled to seek payment on the judgment. Finlayson J.A. agrees with the appellant's position.

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

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

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

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

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

Claims in Bankruptcy

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

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

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

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

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

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

## CONCLUSION

**120** I would dismiss the appeal. For the reasons I have given, the retraction amounts do not constitute a debt or liability within the meaning of s. 121 of the Bankruptcy and Insolvency Act. Even if I am wrong in my conclusion and a debt or liability is created, it is not a claim within the meaning of the

CCAA. This is a case of first impression. For these reasons, I would not award any costs of this appeal.

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

The Issue

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

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

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

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

**125** On June 15, 1992, Houlden J. provided that Central Capital could be reorganized under the Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, and he stayed proceedings against it. Houlden J.'s order of July 9, 1992, which approved the restructuring of Central Capital, was made without prejudice to the right of the appellants to assert claims as creditors. Thus the question for this court is whether the appellants' retraction rights created debts of Central Capital in May 1992. In other words were McCutcheon and SYH Corporation creditors of Central Capital in May 1992? If they were creditors, then like the other unsecured creditors of Central Capital, they can elect to take shares in the newly incorporated company, Canadian Insurance Group Limited; if they were not creditors, then they remain shareholders of Central Capital under the restructuring plan.

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

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

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

I. The Relationship Between the Appellants and Central Capital

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

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

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

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

> when, as here, the equity features are nothing more than supplementary to and not definitive of the essence of the transaction. When a court is searching for the substance of a particular transaction, it should not too easily be distracted by aspects which are, in reality, only incidental or secondary in nature to the main thrust of the agreement.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

**139** Second, there are important factual differences between East Chilliwack and the appeals before us. Justice Weiler has referred to these factual differences in her reasons. The most important of these differences are the following: in East Chilliwack the rules of the association provided that a member had to withdraw from the association to trigger the right of redemption, whereas the appellants' share conditions provide that they continue to be shareholders of Central Capital until their shares are redeemed; in East Chilliwack the member elected to withdraw and redeem his shares when the

association was solvent whereas when the appellant McCutcheon exercised his right of retraction Central Capital was insolvent; and in East Chilliwack Hutcheon J.A. expressly stated that he was not considering the effect of the superintendent's power to suspend payments if the financial position of the co-operative was impaired, whereas the effect of the statutory prohibition against Central Capital making payment, found in s. 36(2) of the Canada Business Corporations Act, is in issue in these appeals.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

> The policy behind the s. 34(2) limitation upon a corporation's power to purchase its own shares seems obvious. It is intended to ensure that one or more shareholders in a corporation do not recoup their investments to the detriment of creditors and other shareholders. It has been observed that:
>
> > Corporate power to purchase its own stock has been frequently abused. Done by corporations conducting faltering businesses, it has been employed to create preferences to the detriment of creditors and of the other stockholders.
> >
> > (Mountain State Steel Foundries, Inc. v. C.I.R., supra, at p. 741 [284 F.2d 737 (1960)].)
>
> Modern business statutes permit these share purchases to take place provided that the position of creditors and other shareholders is protected, by virtue of the application of the s. 34(2) tests.

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

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

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

**151** In other words, the section recognizes that if a company contracts to repurchase its shares but is prohibited from doing so because it is insolvent, the vendor of the shares is not a creditor and on a

liquidation ranks subordinate to the rights of creditors. The shareholder cannot be repaid at the expense of the company's creditors. Although s. 40 does not expressly apply to s. 36, I think that the rationale for s. 40(3) applies to redemptions as well as to repurchases. Whether a repurchase or a redemption, the shareholder is not a creditor and is subordinate to the rights of creditors. More simply the shareholder does not have a provable claim.

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

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

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

Order accordingly.

* * * * *

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

qp/e/qlgxc/qlbxr

# TAB 5

*Indexed as:*

# Blue Range Resource Corp. (Re)

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

[2000] A.J. No. 14

**2000 ABQB 4**

[2000] 4 W.W.R. 738

76 Alta. L.R. (3d) 338

259 A.R. 30

15 C.B.R. (4th) 169

94 A.C.W.S. (3d) 223

Action No. 9901-04070

Alberta Court of Queen's Bench
Judicial District of Calgary

**Romaine J.**

Judgment: filed January 10, 2000.

(84 paras.)

**Counsel:**

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

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## REASONS FOR JUDGMENT

ROMAINE J.:--

### INTRODUCTION

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

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

### FACTS

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

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

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

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

6 Big Bear as the sole shareholder of Blue Range entered into a Unanimous Shareholders'

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

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

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

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

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

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

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

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

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

($3,729,498).

ISSUE #1

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

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

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

Summary of Decision

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

Analysis

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

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

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

sense, Big Bear acquired not only rights but restrictions under corporate law when it acquired the Blue Range shares.

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

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

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

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

**22** In this case, the true nature of Big Bear's claim is more difficult to characterize. There may well be scenarios where the fact that a party with a claim in tort or debt is a shareholder is coincidental and incidental, such as where a shareholder is also a regular trade creditor of a

corporation, or slips and falls outside the corporate office and thus has a claim in negligence against the corporation. In the current situation, however, the very core of the claim is the acquisition of Blue Range shares by Big Bear and whether the consideration paid for such shares was based on misrepresentation. Big Bear had no cause of action until it acquired shares of Blue Range, which it did through share purchases for cash prior to becoming a majority shareholder, as it suffered no damage until it acquired such shares. This tort claim derives from Big Bear's status as a shareholder, and not from a tort unrelated to that status. The claim for misrepresentation therefore is hybrid in nature and combines elements of both a claim in tort and a claim as shareholder. It must be determined what character it has in substance.

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

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

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

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

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

indebtedness, liability or obligation of any kind. Applicable Law includes orders of this Court.

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

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

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

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

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

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

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

**33** Another policy reason which supports subordinating the Big Bear claim is a recognition that creditors conduct business with corporations on the assumption that they will be given priority over shareholders in the event of an insolvency. This assumption was referred to by Laskin, J. in Central

Capital (supra), in legal textbooks (Hadden, Forbes and Simmonds, Canadian Business Organizations Law Toronto: Butterworths, 1984 at 310, 311), and has been explicitly recognized in American case law. The court in In the Matter of Stirling Homex Corporation, 579 F. 2d 206 (1978) U.S.C.A. 2nd Cir. at page 211 referred to this assumption as follows:

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

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

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

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

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

38 The court in McAskill (supra at page 419) in obiter dicta refers to a claim of recission for fraud, and comments that the right to rescind in such a case may be lost due to a change of

circumstances making it unjust to exercise the right. Duff, J. then refers to the long settled principle that a shareholder who has the right to rescind his shares on the ground of misrepresentation will lose that right if he fails to exercise it before the commencement of winding-up proceedings, and comments:

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

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

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

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

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

**43** The first of these cases is Stirling Homex (supra). The issue dealt with by the United States Court of Appeals, Second Circuit, is directly on point: whether claims filed by allegedly defrauded shareholders of a debtor corporation should be subordinated to claims filed by ordinary unsecured creditors for the purposes of formulating a reorganization plan. The court referred to the decision of Pepper v. Litton (308 U.S. 295 at page 305, 60 S.Ct. 238, 84 L. Ed. 281 (1939)) where the Supreme

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

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

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

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

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

47 The final case cited to me on this issue is In re THC Financial 679 F. 2d 784 (1982) (U.S.C.A. 9th Cir.), where again the court concluded that claims of defrauded shareholders must be subordinated to the claims of the general creditors. The court commented that the claimant shareholders had bargained for equity-type profits and equity-type risks in purchasing their shares, and one such risk was the risk of fraud. As pointed out previously, Big Bear had an appreciation of

the risks of proceeding with its takeover bid without access to the books and records of Blue Range and took the deliberate risk of proceeding in any event.

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

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

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

51 The issue of whether equitable subordination as codified in Section 510 of the U.S. Bankruptcy Code should form part of the law in Canada has been raised in several cases but left undecided. Big Bear submits that these cases establish that if equitable subordination is to be part of Canadian law, it should be on the basis of the U.S. three-part test which includes the condition of inequitable conduct. Again, I cannot accept this submission. It is true that Iacobucci, J. in Canada

Deposit Insurance Corp., while he expressly refrains from deciding whether a comparable doctrine should exist in Canada, refers to the three-part test and states that he does not view the facts of the Canada Deposit Insurance Corp. case as giving rise to inequitable conduct. It should be noted, however, that that case did not involve a claim by a shareholder at all, since the lenders had never received the securities that were an option under the agreements, and that the relationship had at this point in the case been characterized as a debtor/creditor relationship.

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

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

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

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

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

application to Canadian business and economy, and I have found them useful in considering this issue.

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

ISSUE #2

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

Summary of Decision

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

Analysis

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

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

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

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

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

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

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

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

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

(C.A.):

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

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

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

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

limitless number of shares from treasury in the future; any loss in this regard would not be equivalent to the actual value of the shares. Therefore, all that is required to return Big Bear to its pre-misrepresentation position is compensation for the actual costs associated with issuing the shares.

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

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

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

73 Finally, there may also be a loss in the form of dilution of the value of the Big Bear shares.

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

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

ISSUE #3

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

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

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

Summary of Decision

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

Analysis

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

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

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

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

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

a) by adding claims for alleged heads of damage other than those specified in the Notice of Claim contrary to the claims bar order of April 6, 1999; and
b) by attempting to include portions of the draft Statement of Claim relating to other alleged heads of damage in the Notice of Claim contrary to the May 11, 1999 order dismissing leave to file the draft Statement of Claim.

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

83 It is true that the Notice of Claim form is not designed for unliquidated tort claims. I do not accept, however, that it was not possible for Big Bear to include claims under other heads of damages in the claim process by, for example, attaching the draft Statement of Claim to the Notice

of Claim, or by incorporating such claims by way of schedule or appendix, as was done with respect to the claims for damages for negligent misrepresentation.

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

ROMAINE J.

cp/i/qljpn

# TAB 6

*Case Name:*

**Parry Sound (District) Social Services Administration Board v. Ontario Public Service Employees Union, Local 324 (O.P.S.E.U.)**

**District of Parry Sound Social Services Administration Board, appellant;**
**v.**
**Ontario Public Service Employees Union, Local 324, respondent, and**
**Ontario Human Rights Commission, intervener.**

[2003] S.C.J. No. 42

[2003] A.C.S. no 42

2003 SCC 42

2003 CSC 42

[2003] 2 S.C.R. 157

[2003] 2 R.C.S. 157

230 D.L.R. (4th) 257

308 N.R. 271

177 O.A.C. 235

J.E. 2003-1790

7 Admin. L.R. (4th) 177

31 C.C.E.L. (3d) 1

[2003] CLLC para. 220-062

125 A.C.W.S. (3d) 85

File No.: 28819.

Supreme Court of Canada

Heard: January 24, 2003;

Judgment: September 18, 2003.

**Present: McLachlin C.J. and Gonthier, Iacobucci, Major, Bastarache, Binnie, Arbour, LeBel and Deschamps JJ.**

(109 paras.)

**Appeal From:**

ON APPEAL FROM THE COURT OF APPEAL FOR ONTARIO

**Catchwords:**

*Labour relations -- Arbitration -- Jurisdiction -- Human rights -- Collective agreement providing that probationary employee may be discharged at sole discretion of and for any reason satisfactory to employer and such discharge not subject to grievance and arbitration procedures -- Probationary employee discharged shortly after return from maternity leave -- Employee filing grievance -- Whether grievance arbitrable -- Whether substantive rights and obligations of Human Rights Code implicitly incorporated within all collective agreements over which arbitrator has jurisdiction -- Labour Relations Act, 1995, S.O. 1995, c. 1, Sch. A, s. 48(1), (12)(j) -- Human Rights Code, R.S.O. 1990, c. H.19, s. 5(1).*

*Labour relations -- Collective agreement -- Grievance -- Procedural requirements -- Arbitration -- Employment standards -- Probationary employee discharged shortly after return from maternity leave -- Employee filing grievance -- Collective agreement providing that grievance must set out section of agreement that is alleged to have been violated -- Employment Standards Act barring discrimination on basis of "pregnancy leave" explicitly incorporated within all collective agreements -- Employment Standards Act claim not raised by Union at any stage of proceedings -- Whether Union's failure to raise Employment Standards Act curable -- Whether s. 64.5(4) of Employment Standards Act binding Union to prior decision not to seek enforcement of the Act -- Whether Court of Appeal erred in raising and resolving appeal on basis of Employment Standards Act -- Employment Standards Act, R.S.O. 1990, c. E.14, ss. 44, 64.5(1).*

**Summary:**

O was a probationary employee of the appellant employer and a member of the respondent Union. Her terms of employment were governed by a collective agreement which states that "a probationary employee may be discharged at the sole discretion of and for any reason satisfactory to the Employer and such action by the Employer is not subject to the grievance and arbitration procedures and does not constitute a difference between the parties". Prior to the expiry of her probationary term, O went on maternity leave. Within a few days of returning to work, the employer discharged her. O filed a grievance.

The majority of the Board of Arbitration found that s. 48(12)(j) of the Ontario *Labour Relations Act, 1995* ("*LRA*"), empowers a board of arbitration to interpret a collective agreement in a manner consistent with the *Human Rights Code* and imports the substantive rights of the *Human Rights Code* into a collective agreement over which an arbitrator has jurisdiction. The Board ruled that it was entitled to consider whether O had been a victim of discrimination under the *Human Rights Code*. The Divisional Court granted the employer's application for judicial review, holding that s. 48(12)(j) confers power on a board of arbitration to interpret and apply the *Human Rights Code* when and if it already has jurisdiction to hear a grievance, but not otherwise. Because the grievance was not a difference arising out of the collective agreement, the Board did not have the jurisdiction to resolve the dispute. The Court of Appeal

set aside the decision. Although the court was inclined to the view that the Divisional Court erred in its application of s. 48(12)(j) of the *LRA*, it preferred not to express a concluded opinion on this question. The court decided the matter with reference to the *Employment Standards Act* ("*ESA*"), noting, first, that s. 44 of the *ESA* provides that an employer shall not dismiss an employee because the employee takes "pregnancy leave" and, second, that under s. 64.5(1) of the *ESA*, the terms and conditions of the *ESA* are enforceable against the employer as if they were a part of the collective agreement. The Court of Appeal concluded, therefore, that the Board had jurisdiction to consider whether O's dismissal was inconsistent with s. 44.

*Held* (Major and LeBel JJ. dissenting): The appeal should be dismissed.

*Per* McLachlin C.J. and Gonthier, Iacobucci, Bastarache, Binnie, Arbour and Deschamps JJ.: The Board was correct to conclude that the substantive rights and obligations of the *Human Rights Code* are incorporated into each collective agreement over which an arbitrator has jurisdiction. Under a collective agreement, the broad rights of an employer to manage the enterprise and direct the work force are subject not only to the express provisions of the collective agreement, but also to statutory provisions of the *Human Rights Code* and other employment-related statutes. The absence of an express provision that prohibits the violation of a particular statutory right is insufficient to conclude that a violation of that right does not constitute a violation of the collective agreement. Rather, human rights and other employment-related statutes establish a floor beneath which an employer and union cannot contract. The plain and ordinary meaning of s. 48(12)(j) of the *LRA*, which provides that an arbitrator has the power "to interpret and apply human rights and other employment-related statutes, despite any conflict between those statutes and the terms of the collective agreement", affirms that grievance arbitrators have not only the power but also the responsibility to implement and enforce the substantive rights and obligations of human rights and other employment-related statutes as if they were part of the collective agreement. Granting arbitrators the authority to enforce the substantive rights and obligations of human rights and other employment-related statutes also advances the stated purposes of the *LRA*, which include promoting the expeditious resolution of workplace disputes, and has the additional advantage of bolstering human rights protection. The fact that the Human Rights Commission currently has greater expertise than the Board in respect of human rights violations is an insufficient basis on which to conclude that a grievance arbitrator ought not to have the power to enforce the rights and obligations of the *Human Rights Code*. An alleged violation of the *Human Rights Code* therefore constitutes an alleged violation of the collective agreement and falls squarely within the Board's jurisdiction. Accordingly, the Board's finding that the discriminatory discharge of a probationary employee is arbitrable is not patently unreasonable and should be upheld.

Even if there was no basis on which to conclude that the alleged violation of the *Human Rights Code* is arbitrable, the application of ss. 44 and 64.5(1) of the *ESA* leads to the conclusion that the subject matter of O's grievance is arbitrable. The joint effect of ss. 44 and 64.5(1) is that each collective agreement is deemed to contain a provision that prohibits the discharge of a probationary employee because she took or intends to take pregnancy leave. Thus, the subject matter of O's grievance clearly constitutes a dispute that arises under a collective agreement over which the Board has jurisdiction.

It was not improper for the Court of Appeal to take into account the fact that the substantive rights and obligations of the *ESA* are incorporated directly into each collective agreement. The finding under review is not the Board's finding that s. 5(1) of the *Human Rights Code* is enforceable against the employer, but its finding that O's grievance is arbitrable. If the Court of Appeal had upheld the Divisional Court's decision to reverse the arbitration award without taking into account the potential impact of ss. 44 and 64.5(1) of the *ESA*, it would arguably have committed an error of law.

The Union was not bound by its prior decision not to seek enforcement of s. 44 of the *ESA* at the initial

hearing. The purpose of s. 64.5(4) of the *ESA* is not to bind a union to such a prior decision, but, rather, to affirm the principle that an employee to whom a collective agreement applies is not entitled to file or maintain a complaint under the Act.

Lastly, the Union's failure to comply with the procedural requirements of the collective agreement, which demand that a discharge grievance must set out the section of the collective agreement that is alleged to have been violated, does not preclude the Union from subsequently raising s. 44 of the *ESA* as a potential basis of liability. Procedural requirements should not be stringently enforced in those instances where, as here, the employer suffered no prejudice.

*Per* Major and LeBel JJ. (dissenting): O's *Human Rights Code* claim is not the subject of the agreement between her employer and her Union, and is therefore not arbitrable. Unless the legislature passes legislation incorporating the substance of its statutes into collective agreements, it is to be assumed that unions and employers may define which employees and disputes are covered by a collective agreement and therefore have access to binding arbitration, as long as the agreement does not conflict with statute or public policy. Absent legislative action, courts should not on their own initiative interfere with the terms of a collective agreement. Here, the *Human Rights Code* is not implicitly incorporated into all collective agreements. To read into s. 48(12)(j) of the *LRA* the extraordinary power to take jurisdiction of any claim based on statute, despite the plain wishes of the parties to the contract, is a subversion of the legislative intent. If the legislature wished to thus expand the power of arbitrators, it would have signalled its intent more clearly. O's dismissal is not arbitrable because her Union and her employer agreed not to cover the dismissal of probationary employees in their collective agreement, and the legislature did not intend to require that they do so.

It was improper for the Court of Appeal, *sua sponte*, to ignore the procedural requirements negotiated by the parties and raise the *ESA* argument. Article 8.06(a) of the collective agreement clearly required the Union to state "the section or sections of the Agreement which are alleged to have been violated". The Union should therefore have raised s. 44 of the *ESA*, barring employment discrimination on the basis of "pregnancy leave", which the legislature has explicitly incorporated into all collective agreements via s. 64.5(1) of the *ESA*. This the Union chose not to do. Even if the failure to raise the *ESA* might have been curable or seen as a simple procedural defect, the Union would at the very least have had the obligation to raise the matter at the arbitration stage. The Union and O should be bound by the specific claims they made and the manner in which they presented them. The Court of Appeal erred in raising this issue, not chosen by the parties.

O is not without a remedy. She may use the mechanisms carefully set out by the legislature to vindicate her human rights, and may bring her claim before the Human Rights Commission, as the employer urged and as the legislature intended.

**Cases Cited**

By Iacobucci J.

Applied: McLeod v. Egan, [1975] 1 S.C.R. 517; referred to: Volvo Canada Ltd. v. U.A.W., Local 720, [1980] 1 S.C.R. 178; Douglas Aircraft Co. of Canada v. McConnell, [1980] 1 S.C.R. 245; Dayco (Canada) Ltd. v. CAW-Canada, [1993] 2 S.C.R. 230; Toronto (City) Board of Education v. O.S.S.T.F., District 15, [1997] 1 S.C.R. 487; Canada (Director of Investigation and Research) v. Southam Inc., [1997] 1 S.C.R. 748; C.U.P.E. v. Ontario (Minister of Labour), [2003] 1 S.C.R. 539, 2003 SCC 29; Canadian Broadcasting Corp. v. Canada (Labour Relations Board), [1995] 1 S.C.R. 157; United Brotherhood of Carpenters and Joiners of America, Local 579 v. Bradco Construction Ltd., [1993] 2 S.C.R. 316; Goodyear Tire & Rubber Co. of Canada v. T. Eaton Co., [1956] S.C.R. 610; Slaight Communications Inc. v. Davidson, [1989] 1 S.C.R. 1038; Rizzo & Rizzo Shoes Ltd. (Re), [1998] 1

S.C.R. 27; Heustis v. New Brunswick Electric Power Commission, [1979] 2 S.C.R. 768; Blanchard v. Control Data Canada Ltd., [1984] 2 S.C.R. 476; Suresh v. Canada (Minister of Citizenship and Immigration), [2002] 1 S.C.R. 3, 2002 SCC 1; Re Blouin Drywall Contractors Ltd. and United Brotherhood of Carpenters and Joiners of America, Local 2486 (1975), 8 O.R. (2d) 103; Spruce Falls Inc. and I.W.A.-Canada, Local 2995 (Trudel) (Re) (2002), 106 L.A.C. (4th) 41; Peel District School Board and O.P.S.T.F., District 19 (Havery) (Re) (2000), 84 L.A.C. (4th) 289; Re Harry Woods Transport Ltd. and Teamsters Union, Local 141 (1977), 15 L.A.C. (2d) 140; Aro Canada Inc. and I.A.M., Re (1988), 34 L.A.C. (3d) 255; Liquid Carbonic Inc. and U.S.W.A., Re (1992), 25 L.A.C. (4th) 144.

By Major J. (dissenting)

McLeod v. Egan, [1975] 1 S.C.R. 517; Bank of Toronto v. Perkins (1883), 8 S.C.R. 603.

**Statutes and Regulations Cited**

Employment Standards Act, R.S.O. 1990, c. E.14, ss. 44, 64.5(1)-(4) [ad. 1996, c. 23, s. 18].

Employment Standards Act, 1968, S.O. 1968, c. 35, s. 11(2).

Human Rights Code, R.S.O. 1990, c. H.19, s. 5(1) [am. 1999, c. 6, s. 28(5)].

Labour Relations Act, R.S.O. 1990, c. L.2, s. 45(8)3 [rep. & sub. 1992, c. 21, s. 23(3)].

Labour Relations Act, 1995, S.O. 1995, c. 1, Sch. A., s. 48(1), (12).

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**History and Disposition:**

APPEAL from a judgment of the Ontario Court of Appeal (2001), 54 O.R. (3d) 321, 147 O.A.C. 183, 10 C.C.E.L. (3d) 290, 40 C.H.R.R. D/190, 2002 C.L.L.C. para. 210-005, [2001] O.J. No. 2316 (QL), setting aside a judgment of the Divisional Court (2000), 131 O.A.C. 122, 2000 C.L.L.C. para. 220-336, [2000] O.J. No. 475 (QL). Appeal dismissed, Major and LeBel JJ. dissenting.

**Counsel:**

William G. Horton, Cathy Beagan Flood and Robert B. Budd, for the appellant.

Timothy G. M. Hadwen and Peggy E. Smith, for the respondent.

Naomi Overend and Prabhu Rajan, for the intervener.

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The judgment of McLachlin C.J. and Gonthier, Iacobucci, Bastarache, Binnie, Arbour and Deschamps JJ. was delivered by

**1 IACOBUCCI J.**:-- This appeal raises questions about the application of human rights and other employment-related statutes in the context of a collective agreement. More specifically, does a grievance arbitrator have the power to enforce the substantive rights and obligations of human rights and other employment-related statutes and, if so, under what circumstances? As I discuss in these reasons, I conclude that a grievance arbitrator has the power and responsibility to enforce the substantive rights and obligations of human rights and other employment-related statutes as if they were part of the collective agreement. Consequently, I would dismiss the appeal.

I. Background

**2** Joanne O'Brien was a probationary employee of the appellant District of Parry Sound Social Services Administration Board and a member of the respondent Ontario Public Service Employees Union (the "Union"). Her terms of employment were governed by a collective agreement negotiated between the parties. For the purposes of this appeal, the most important provision of the collective agreement is Article 5.01:

**ARTICLE 5 -- MANAGEMENT RIGHTS**

**5.01** The Union recognizes that the management of the operations and the direction of the employees are fixed exclusively in the Employer and shall remain solely with the Employer except as expressly limited by the clear and explicit language of some other provision of this Agreement and, without restricting the generality of the foregoing, the Union acknowledges that it is the exclusive function of the Employer to:

...

(b) hire, assign, retire, promote, demote, classify, transfer, direct, lay off, recall and to suspend, discipline or discharge employees who have successfully completed their probationary period for just cause provided that a claim by an employee who has successfully completed his/her probationary period that she/he has been disciplined, suspended or discharged without just cause may be the subject of a grievance and dealt with as hereinafter provided;

**3** Under Article 5.01, the Union recognizes that management has the right to manage the enterprise and direct the work force, subject only to express provisions of the collective agreement that provide

otherwise. On its face, Article 5.01 is sufficiently broad to include the right of the employer to discharge an employee. Under paragraph (b), a claim by an employee who has successfully completed his or her probationary period that she or he has been disciplined without just cause may be the subject of a grievance. The right of the appellant to manage the enterprise is thus subject to the right of an employee who has completed the probationary period not to be discharged without just cause. There is no provision that limits the right of the employer to discharge a probationary employee. To the contrary, Article 8.06(a), under the heading "Grievance Procedure", states that "a probationary employee may be discharged at the sole discretion of and for any reason satisfactory to the Employer and such action by the Employer is not subject to the grievance and arbitration procedures and does not constitute a difference between the parties".

**4** Prior to the expiry of her probationary term, Ms. O'Brien went on maternity leave. Within a few days of returning to work, the appellant discharged her. On June 26, 1998, Ms. O'Brien filed a grievance with the Union. The grievance alleged as follows:

> I grieve that I have been discharged from my position without justification and that this decision was arbitrary, discriminatory, in bad faith and unfair.

At the arbitration hearing, the appellant objected on the basis that the Board of Arbitration (the "Board") did not have jurisdiction over the subject matter of the grievance. It was the appellant's submission that the collective agreement clearly expressed that it was the parties' intention that the discharge of a probationary employee was not arbitrable. The appellant submitted that the parties have the right to make such a bargain and that it would be a jurisdictional error for the Board to resolve the dispute.

II. Relevant Legislative Provisions

**5** *Employment Standards Act*, R.S.O. 1990, c. E.14

> **44.** An employer shall not intimidate, discipline, suspend, lay off, dismiss or impose a penalty on an employee because the employee is or will become eligible to take, intends to take or takes pregnancy leave or parental leave.
>
> **64.5** (1) If an employer enters into a collective agreement, the Act is enforceable against the employer with respect to the following matters as if it were part of the collective agreement:
>
> 1. A contravention of or failure to comply with the Act that occurs when the collective agreement is in force.
>
> ...
>
> (2) An employee to whom a collective agreement applies (including an employee who is not a member of the trade union) is not entitled to file or maintain a complaint under the Act.
>
> (3) Despite subsection (2), the Director may permit an employee to file or maintain a complaint under the Act if the Director considers it appropriate in the circumstances.
>
> (4) An employee to whom a collective agreement applies (including an employee who is not a member of the trade union) is bound by a decision of the trade

union with respect to the enforcement of the Act under the collective agreement, including a decision not to seek the enforcement of the Act.

*Labour Relations Act, 1995*, S.O. 1995, c. 1, Sch. A

**48.** (1) Every collective agreement shall provide for the final and binding settlement by arbitration, without stoppage of work, of all differences between the parties arising from the interpretation, application, administration or alleged violation of the agreement, including any question as to whether a matter is arbitrable.

...

(12) An arbitrator or the chair of an arbitration board, as the case may be, has power,

(a) to require any party to furnish particulars before or during a hearing;
(b) to require any party to produce documents or things that may be relevant to the matter and to do so before or during the hearing;
(c) to fix dates for the commencement and continuation of hearings;
(d) to summon and enforce the attendance of witnesses and to compel them to give oral or written evidence on oath in the same manner as a court of record in civil cases; and
(e) to administer oaths and affirmations,

and an arbitrator or an arbitration board, as the case may be, has power,

(f) to accept the oral or written evidence as the arbitrator or the arbitration board, as the case may be, in its discretion considers proper, whether admissible in a court of law or not;

(g) to enter any premises where work is being done or has been done by the employees or in which the employer carries on business or where anything is taking place or has taken place concerning any of the differences submitted to the arbitrator or the arbitration board, and inspect and view any work, material, machinery, appliance or article therein, and interrogate any person respecting any such thing or any of such differences;

(h) to authorize any person to do anything that the arbitrator or arbitration board may do under clause (g) and to report to the arbitrator or the arbitration board thereon;
(i) to make interim orders concerning procedural matters;
(j) to interpret and apply human rights and other employment-related statutes, despite any conflict between those statutes and the terms of the collective agreement.

*Human Rights Code*, R.S.O. 1990, c. H.19

**5.**--(1) Every person has a right to equal treatment with respect to employment without discrimination because of race, ancestry, place of origin, colour, ethnic origin, citizenship, creed, sex, sexual orientation, age, record of offences, marital

status, same-sex partnership status, family status or handicap.

III. Judicial History

A. *Arbitration Award (February 1, 1999)*

**6** The majority of the Board found that the collective agreement, considered alone, imposed no restriction on the right of the employer to discharge probationary employees. The language of the collective agreement clearly indicated that it was not the parties' intention that the discharge of a probationary employee would be arbitrable.

**7** The majority of the Board then considered the impact of s. 48(12)(j) of the *Labour Relations Act, 1995* ("*LRA*"). The Board found that s. 48(12)(j) obligates and empowers a board of arbitration to interpret a collective agreement in a manner consistent with the *Human Rights Code*. Section 48(12)(j) , in other words, imports the substantive rights of the *Human Rights Code* into a collective agreement over which an arbitrator has jurisdiction. The majority of the Board thus determined that it had the power and responsibility to hear and determine the narrow question of whether discrimination was a factor in the discharge of Ms. O'Brien.

**8** Board member O'Byrne dissented on the basis that s. 48(12)(j) of the *LRA* can only be utilized if an arbitrator has jurisdiction in the first instance. In his view, the fact that the difference did not arise out of the express terms and conditions of the collective agreement should have been sufficient to dispose of the matter. He concluded that the Board did not have jurisdiction to resolve this dispute.

B. *Ontario Superior Court of Justice (Divisional Court)* (2000), 131 O.A.C. 122

**9** On an application for judicial review, O'Leary J. held that s. 48(12)(j) of the *LRA* confers power on a board of arbitration to interpret and apply the *Human Rights Code* when and if it already has jurisdiction to hear a grievance, but not otherwise. On this view, the Board has jurisdiction only over differences between the parties arising from the interpretation, application, administration or alleged violation of the express terms and conditions of the collective agreement. Because the grievance was not a difference arising out of the collective agreement, O'Leary J. was of the view that the Board did not have the jurisdiction to resolve the dispute. If there is no difference arising out of the four corners of the collective agreement, s. 48(12)(j) is of no application.

C. *Ontario Court of Appeal* (2001), 54 O.R. (3d) 321

**10** According to Morden J.A., the approach adopted by the Divisional Court gives too narrow a meaning to s. 48(12)(j) of the *LRA*. In his view, s. 48(12)(j) requires arbitrators to interpret the collective agreement in the context of the relevant statutory provisions. The collective agreement must be read in light of human rights and other employment-related statutes. If the terms of the collective agreement are in conflict with the *Human Rights Code*, the *Human Rights Code* will prevail. Applying this reasoning to the facts of this case, Morden J.A. found that the right of the employer under the collective agreement to discharge a probationary employee "for any reason satisfactory to the employer" is in direct conflict with s. 5(1) of the *Human Rights Code*. He concluded that Article 8.06 should be read down not to include the power to discharge for discriminatory reasons.

**11** In the end, however, Morden J.A. chose not to rely on the preceding analysis for the purpose of disposing of the appeal. His reasoning was that he felt that the requirement of an express conflict between the statute and the collective agreement could involve some incongruity. In his view, the requirement of a direct conflict between the statute and the agreement would have the incongruous result that an arbitrator will find the dispute arbitrable and resolve it on the basis of the external statute where

the parties have said something inconsistent with the statute, but not where they have said nothing at all on the matter. Noting that this feature of s. 48(12)(j) results in some uncertainty regarding the scope of its application, Morden J.A. chose not to resolve the matter on this basis.

**12** Instead, Morden J.A. decided the matter with reference to the *Employment Standards Act* ("*ESA*"), which he considered to be a much firmer ground. Morden J.A. first noted that s. 44 of the *ESA* provides that an employer shall not dismiss an employee because the employee takes pregnancy leave or parental leave. He then noted that under s. 64.5(1) of the *ESA* the terms and conditions of the Act are enforceable against the employer as if they were a part of the collective agreement. In view of the direct incorporation of the *ESA* into the collective agreement, Morden J.A. found that the Board had jurisdiction to consider whether the dismissal of Ms. O'Brien was inconsistent with s. 44 of the *ESA*.

**13** Morden J.A. rejected the appellant's submission that the court should not resolve the matter with reference to the *ESA* because the statute was not raised before the Board; he did so on the basis that the appellant would suffer no prejudice if the matter was resolved in this manner. Having concluded that the Board had jurisdiction to resolve the grievance, Morden J.A. allowed the appeal and made an order dismissing the application for judicial review.

## IV. Issues

**14** The principal question in this appeal concerns the Board's finding that Ms. O'Brien's grievance is arbitrable. In reviewing this finding, the primary substantive question to be answered is whether the substantive rights and obligations of the *Human Rights Code* are incorporated into a collective agreement over which the Board has jurisdiction. A second question that arises is whether it was appropriate for the Court of Appeal to determine that the subject matter of the grievance is arbitrable on the basis that the substantive rights and obligations of the *ESA* are incorporated into the collective agreement.

**15** I also note that the Ontario Human Rights Commission has intervened in this appeal for the purpose of ensuring that its jurisdiction is not ousted because the aggrieved employee is a party to a collective agreement over which the Board has jurisdiction. The Commission submits that if the Court finds that the grievance is arbitrable, the Board and the Commission have concurrent jurisdiction. In my view, it is unnecessary to determine this matter at the present time. Consequently, in concluding that a grievance arbitrator has the power and responsibility to enforce the substantive rights and obligations of the *Human Rights Code* in this case, I make no holding on whether the jurisdiction of the Human Rights Commission is ousted by that of the Board.

## V. Analysis

### A. *What is the Appropriate Standard of Review?*

**16** Where an arbitration board is called upon to determine whether a matter is arbitrable, it is well-established that a reviewing court can only intervene in the case of a patently unreasonable error. See for example *Volvo Canada Ltd. v. U.A.W., Local 720*, [1980] 1 S.C.R. 178; *Douglas Aircraft Co. of Canada v. McConnell*, [1980] 1 S.C.R. 245; *Dayco (Canada) Ltd. v. CAW-Canada*, [1993] 2 S.C.R. 230 ; and *Toronto (City) Board of Education v. O.S.S.T.F., District 15*, [1997] 1 S.C.R. 487.

**17** This high degree of curial deference to the decisions of arbitration boards is necessary to maintain the integrity of the grievance arbitration process. As Cory J. wrote in *Toronto Board of Education, supra*, at para. 36, "the whole purpose of a system of grievance arbitration is to secure prompt, final and binding settlement of disputes arising out of the interpretation or application of collective agreements and the disciplinary actions taken by an employer". This is a basic requirement for peace and harmony in

industrial relations, which is important both to the parties and to society as a whole. The protective clause found in s. 48(1) of the *LRA* is the legislative recognition that the basic nature of labour disputes requires their prompt and final resolution by expert tribunals.

**18** The patent unreasonableness standard is a very high standard that will not easily be met. In *Canada (Director of Investigation and Research) v. Southam Inc.*, [1997] 1 S.C.R. 748, at para. 57, the Court described the difference between an unreasonable and patently unreasonable decision in the following terms:

> The difference ... lies in the immediacy or obviousness of the defect. If the defect is apparent on the face of the tribunal's reasons, then the tribunal's decision is patently unreasonable. But if it takes some significant searching or testing to find the defect, then the decision is unreasonable but not patently unreasonable. As Cory J. observed in *Canada (Attorney General) v. Public Service Alliance of Canada*, [1993] 1 S.C.R. 941, at p. 963, "[i]n the Shorter Oxford English Dictionary 'patently', an adverb, is defined as 'openly, evidently, clearly'". This is not to say, of course, that judges reviewing a decision on the standard of patent unreasonableness may not examine the record. If the decision under review is sufficiently difficult, then perhaps a great deal of reading and thinking will be required before the judge will be able to grasp the dimensions of the problem... . <u>But once the lines of the problem have come into focus, if the decision is patently unreasonable, then the unreasonableness will be evident.</u> [Emphasis added.]

See also *C.U.P.E. v. Ontario (Minister of Labour)*, [2003] 1 S.C.R. 539, 2003 SCC 29.

B. *Was the Arbitration Award Patently Unreasonable?*

**19** As La Forest J. noted in *Dayco, supra*, at p. 251, the collective agreement is the "foundation" of a grievance arbitrator's jurisdiction. Absent a violation of the collective agreement, a grievance arbitrator has no jurisdiction over a dispute; if the alleged misconduct does not constitute a violation of the collective agreement, there is no basis on which to conclude that a dispute is arbitrable.

**20** In the present case, the parties are in agreement that the express provisions of the collective agreement in question impose no fetters on the employer's right to discharge a probationary employee. The Union, however, submits that s. 5(1) of the *Human Rights Code* is implicit in the collective agreement between the parties. If this is the case, there is no doubt that the discriminatory discharge of a probationary employee is arbitrable. Under s. 5(1), every person has a right to equal treatment with respect to employment without discrimination. Ms. O'Brien's grievance -- that she was discharged for discriminatory reasons -- falls squarely within s. 5(1) of the *Human Rights Code*. If s. 5(1) is implicit in the collective agreement between the parties, the grievance falls squarely within the ambit of the collective agreement as well. But if s. 5(1) of the *Human Rights Code* is <u>not</u> incorporated into the collective agreement between the parties, it is equally obvious that the discriminatory discharge of a probationary employee is not arbitrable.

**21** Consequently, the critical issue to be determined at the arbitration hearing was whether or not the substantive rights and obligations of the *Human Rights Code* are incorporated into each collective agreement over which the Board has jurisdiction. Put a different way, it is only once this issue has been resolved that the lines of the problem come into focus. This, in my opinion, is an issue that the Board must resolve correctly. As the Court concluded in *Canadian Broadcasting Corp. v. Canada (Labour Relations Board)*, [1995] 1 S.C.R. 157, at para. 49, there may be instances in which the reasonableness of a tribunal's decision is dependent on it having correctly answered a question of law in the course of reaching that decision. If the critical question that the tribunal must answer is a question of law that is

outside its area of expertise and that the legislature did not intend to leave to the tribunal, the tribunal must answer that question correctly.

**22** The question of whether the substantive rights and obligations of the *Human Rights Code* are incorporated into each collective agreement over which the Board has jurisdiction is not, in my view, a question that the legislature intended to leave to the Board. The Board's expertise does not lie in answering legal questions of general applicability, but, rather, in the interpretation of collective agreements and the resolution of factual disputes related to those agreements. See for example *Dayco, supra*, at p. 266, and *United Brotherhood of Carpenters and Joiners of America, Local 579 v. Bradco Construction Ltd.*, [1993] 2 S.C.R. 316, at p. 336. Determining whether the substantive rights and obligations of an external statute are incorporated into a collective agreement is a legal question of broad applicability that does not fall within an arbitrator's core area of expertise. Although the Board has the power to determine whether the substantive rights and obligations of the *Human Rights Code* are incorporated into the collective agreement, the Court has the power to interfere if the Board resolved the issue incorrectly.

**23** For the reasons that follow, it is my conclusion that the Board was correct to conclude that the substantive rights and obligations of the *Human Rights Code* are incorporated into each collective agreement over which the Board has jurisdiction. Under a collective agreement, the broad rights of an employer to manage the enterprise and direct the work force are subject not only to the express provisions of the collective agreement, but also to statutory provisions of the *Human Rights Code* and other employment-related statutes.

(1) The Case Law

**24** The leading case regarding the effect of employment-related statutes on the content of collective agreements is *McLeod v. Egan*, [1975] 1 S.C.R. 517. Prior to *McLeod*, the prevailing view was that an arbitrator was not authorized to apply statutes in the course of grievance arbitration other than as an aid to interpreting a collective agreement: D. J. M. Brown and D. M. Beatty, *Canadian Labour Arbitration* (loose-leaf ed.), at p. 2-60. On this view, an arbitrator had no alternative but to construe and apply a collective agreement in accordance with its express terms and conditions. If the alleged misconduct did not constitute a violation of an express provision of the collective agreement, the subject matter of the dispute was not arbitrable. In *McLeod*, however, the Court established that it is necessary to look outside the collective agreement in order to ascertain the substantive rights and obligations of the parties to that agreement.

**25** In *McLeod*, the appellant employee alleged that he had been disciplined for refusing to work beyond 48 hours in a week. The collective agreement between the parties contained a broad management rights clause that expressly stated that the control of all operations and working forces, including the right to discipline employees and to schedule operations, is vested solely in the employer, subject only to the express provisions of the collective agreement. There were no provisions of the collective agreement that limited the right of an employer to require an employee to work overtime beyond 48 hours a week. In the absence of language limiting the broad power vested in the employer, the arbitrator concluded that insofar as the collective agreement was concerned the employer was entitled to discipline an employee who refused to work in excess of 48 hours a week.

**26** The Court, however, concluded that an arbitrator must look beyond the four corners of the collective agreement in order to determine the limits on an employer's right to manage operations. Under a collective agreement, this right is subject not only to the express provisions of the agreement, but also to statutory provisions such as s. 11(2) of the *Employment Standards Act, 1968*, S.O. 1968, c. 35 (the "*ESA, 1968*"). Martland J. held as follows, at p. 523:

> The basic provision of the Act is that which places a maximum limit upon the working hours of an employee of eight in the day and forty-eight in the week. Any provision of an agreement which purported to give to an employer an unqualified right to require working hours in excess of those limits would be illegal, and the provisions of art. 2.01 of the collective agreement, which provided that certain management rights should remain vested in the Company, could not, in so far as they preserved the Company's right to require overtime work by its employees, enable the Company to require overtime work in excess of those limits.

Put another way, the absence of a provision that expressly prohibits an employer from requiring an employee to work in excess of 48 hours a week does not mean that the right to manage operations includes the right to violate s. 11(2) of the *ESA, 1968*. Management rights must be exercised not only in accordance with the express provisions of the collective agreement, but also in accordance with the employee's statutory rights. As Martland J. concluded, at p. 524, "[b]y the operation of the statute, the right to require overtime beyond 48 hours per week from any individual employee had been taken away from the employer and became subject to the rights of the employee under s. 11(2)".

**27** Major J. states that this case stands for the proposition that a union and employer are restricted from making an agreement contrary to law. This rule, he states, is no more than a modern application of a long-standing rule that courts will not enforce contracts that are illegal or against public policy. This may be true, but I believe it important to consider carefully what it was that made the collective agreement in *McLeod* objectionable. In *McLeod*, the collective agreement did not expressly state that the employer was authorized to require overtime beyond 48 hours a week. It did, however, contain a broad management rights clause that recognized the employer's right to control all operations and working forces, including the right to discipline employees and to schedule operations. The collective agreement was objectionable because the powers it extended to the employer were sufficiently broad to include the power to violate its employees' rights under s. 11(2) of the *ESA, 1968*.

**28** As a practical matter, this means that the substantive rights and obligations of employment-related statutes are implicit in each collective agreement over which an arbitrator has jurisdiction. A collective agreement might extend to an employer a broad right to manage the enterprise as it sees fit, but this right is circumscribed by the employee's statutory rights. The absence of an express provision that prohibits the violation of a particular statutory right is insufficient to conclude that a violation of that right does not constitute a violation of the collective agreement. Rather, human rights and other employment-related statutes establish a floor beneath which an employer and union cannot contract.

**29** As a result, the substantive rights and obligations of the parties to a collective agreement cannot be determined solely by reference to the mutual intentions of the contracting parties as expressed in that agreement. Under *McLeod*, there are certain terms and conditions that are implicit in the agreement, irrespective of the mutual intentions of the contracting parties. More specifically, a collective agreement cannot be used to reserve the right of an employer to manage operations and direct the work force otherwise than in accordance with its employees' statutory rights, either expressly or by failing to stipulate constraints on what some arbitrators regard as management's inherent right to manage the enterprise as it sees fit. The statutory rights of employees constitute a bundle of rights to which the parties can add but from which they cannot derogate.

**30** In some sense, *McLeod* is inconsistent with the traditional view that a collective agreement is a private contract between equal parties, and that the parties to the agreement are free to determine what does or does not constitute an arbitrable difference. But this willingness to consider factors other than the parties' expressed intention is consistent with the fact that collective bargaining and grievance

arbitration has both a private and public function. The collective agreement is a private contract, but a contract that serves a public function: the peaceful resolution of labour disputes. See for example Professor P. Weiler, "The Remedial Authority of the Labour Arbitrator: Revised Judicial Version" (1974), 52 *Can. Bar Rev.* 29, at p. 31. This dual purpose is reflected in the fact that the content of a collective agreement is, in part, fixed by external statutes. Section 48(1) of the *LRA*, for example, dictates that every collective agreement must provide for final and binding settlement by arbitration of all differences arising under a collective agreement. Section 64.5(1) of the *ESA* provides that the Act is enforceable against an employer as if it was part of the collective agreement. In each collective agreement, certain procedural requirements and substantive rights and obligations are mandatory. In *McLeod*, the Court determined that these include the obligation of an employer to exercise its management rights in accordance with the statutory rights of its employees.

(2) Application of the Case Law

31 As in *McLeod*, the collective agreement at issue in this appeal expressly recognizes the employer's broad right to manage the enterprise and direct the work force as it sees fit, subject only to express terms providing otherwise. Article 5.01, under the heading "Management Rights", provides as follows:

> **5.01** The Union recognizes that the management of the operations and the direction of the employees are fixed exclusively in the Employer and shall remain solely with the Employer except as expressly limited by the clear and explicit language of some other provision of this Agreement ...

Under the traditional view, the management rights recognized therein are unlimited, except to the extent that the express provisions of the collective agreement provide otherwise. In the absence of a provision in the collective agreement that limits the right of the employer to discharge a probationary employee for discriminatory reasons, Ms. O'Brien's grievance is non-arbitrable.

32 Under *McLeod*, a collective agreement cannot extend to an employer the right to violate the statutory rights of its employees. On the contrary, the broad power of the appellant to manage operations and direct employees is subject not only to the express provisions of the agreement, but also to the statutory rights of its employees. Just as the collective agreement in *McLeod* could not extend to the employer the right to require overtime in excess of 48 hours, the collective agreement in the current appeal cannot extend to the appellant the right to discharge an employee for discriminatory reasons. Under a collective agreement, as under laws of general application, the right to direct the work force does not include the right to discharge a probationary employee for discriminatory reasons. The obligation of an employer to manage the enterprise and direct the work force is subject not only to express provisions of the collective agreement, but also to the statutory rights of its employees, including the right to equal treatment in employment without discrimination.

33 The one factor that distinguishes this case from *McLeod* is the fact that there is more evidence that the parties to the agreement specifically turned their minds to the subject matter of the grievance and agreed that it was not arbitrable. In *McLeod*, the collective agreement contained a broad management rights clause, but did not directly address the right of the employer to require overtime beyond 48 hours a week. Thus, it is difficult to prove with any degree of certainty that it was the mutual intention of the parties that the collective agreement extend to the employer the right to require overtime in violation of s. 11(2) of the *ESA, 1968*. In this case, the collective agreement contains both a broad management rights clause and an express statement that "[n]otwithstanding anything in this Agreement, a

probationary employee may be discharged at the sole discretion of and for any reason satisfactory to the Employer and such action by the Employer is not subject to the grievance and arbitration procedures and does not constitute a difference between the parties". Article 8.06(a) might be understood as an explicit expression of the parties' mutual intention that the discriminatory discharge of a probationary employee is not arbitrable.

**34** In response to this line of argument, I should state that I am not entirely comfortable attributing this intention to the parties. Although the language of Article 8.06(a) is broad, it cannot be established, as a matter of fact, that the parties reached a common understanding that the discriminatory discharge of a probationary employee is non-arbitrable. It is more likely, in my view, that the mutual intention was to affirm the right of the employer to discharge a probationary employee who did not perform his or her tasks to the employer's satisfaction. As O'Leary J. rightly observed, it is sometimes difficult for an employer to assess a candidate without hiring that employee for a probationary period; it is not unreasonable that the employer would have the right to assess whether the probationary employee has adequately satisfied the requirements of the post. I find it unlikely, however, that it was the parties' mutual intention to affirm the right of the employer to discharge a probationary employee on the basis of human rights grounds, namely, race, ancestry, place of origin, colour, ethnic origin, citizenship, creed, sex, sexual orientation, age, record of offences, marital status, same-sex partnership status, family status or handicap.

**35** But even if Article 8.06(a) does, in fact, reflect a common intention that the discriminatory discharge of a probationary employee is not an arbitrable dispute, I remain of the view that Ms. O'Brien's grievance is arbitrable. One reason I say this is that s. 48(1) of the *LRA* states that every collective agreement shall provide for the final and binding settlement by arbitration of all differences between the parties arising under the collective agreement. Section 48(1) prohibits the parties from enacting provisions stating that a violation of the collective agreement is non-arbitrable. By the operation of s. 5(1) of the *Human Rights Code*, the right of probationary employees to equal treatment without discrimination is implicit in the collective agreement, and thus the discriminatory discharge of a probationary employee constitutes a violation of that agreement. To the extent that Article 8.06(a) establishes that an allegation that the discriminatory discharge of a probationary employer is non-arbitrable, it is void as contrary to s. 48(1) of the *LRA*.

**36** More fundamentally, the interpretation of Article 8.06(a) that it reflects a common intention is inconsistent with the principle that under a collective agreement an employer's right to manage operations and direct the work force is subject not only to the express provisions of the collective agreement but also to the employees' statutory rights, irrespective of the parties' subjective intentions. In *McLeod*, the Court stated that any provision that purports to give to an employer the right to require working hours in excess of 48 hours a week is void. The same logic applies to a provision that purports to give to an employer the right to discharge a probationary employee for discriminatory reasons. Even if the parties to the agreement had enacted a substantive provision that clearly expressed that, insofar as the collective agreement is concerned, the employer possessed the right to discharge a probationary employee for discriminatory reasons, that provision would be void. Put simply, there are certain rights and obligations that arise irrespective of the parties' subjective intentions. These include the right of an employee to equal treatment without discrimination and the corresponding obligation of an employer not to discharge an employee for discriminatory reasons. To hold otherwise would lessen human rights protection in the unionized workplace by allowing employers and unions to treat such protections as optional, thereby leaving recourse only to the human rights procedure.

**37** The effect of my analysis is to modify Article 8.06(a). Under this analysis, it is only a probationary employee being discharged "at the sole lawful discretion of and for any lawful reason satisfactory to the Employer" that does not constitute a difference between the parties. Any exercise of this discretion

otherwise than in accordance with a probationary employee's rights under the *Human Rights Code* and other employment-related statutes is an arbitrable difference under the collective agreement.

(3) Section 48(12)(j) of the *LRA*

**38** Having determined that *McLeod* established that an employer's right to manage the operations and direct the work force is subject not only to the express provisions of the collective agreement but also to the right of each employee to equal treatment without discrimination, the question that arises is whether this principle applies under s. 48(12)(j) of the *LRA*. Put directly, did the enactment of s. 48(12)(j) displace or otherwise restrict the principles established in *McLeod*? If it did not, the Board was correct to conclude that the substantive rights and obligations of the *Human Rights Code* are implicit in a collective agreement over which an arbitrator has jurisdiction.

**39** To begin with, I think it useful to stress the presumption that the legislature does not intend to change existing law or to depart from established principles, policies or practices. In *Goodyear Tire & Rubber Co. of Canada v. T. Eaton Co.*, [1956] S.C.R. 610, at p. 614, for example, Fauteux J. (as he then was) wrote that "a Legislature is not presumed to depart from the general system of the law without expressing its intentions to do so with irresistible clearness, failing which the law remains undisturbed". In *Slaight Communications Inc. v. Davidson*, [1989] 1 S.C.R. 1038, at p. 1077, Lamer J. (as he then was) wrote that "in the absence of a clear provision to the contrary, the legislator should not be assumed to have intended to alter the pre-existing ordinary rules of common law".

**40** In my view, s. 48(12)(j) does not clearly indicate that it was the legislature's intention to alter the principles described above. Quite the opposite. I believe that the amendments to the legislation affirm that grievance arbitrators have not only the power but also the responsibility to implement and enforce the substantive rights and obligations of human rights and other employment-related statutes as if they were part of the collective agreement. If the right of an employer to manage operations and direct the work force is subject to both the express provisions of the collective agreement and the employee's statutory rights, then it follows that a grievance arbitrator must have the power to implement and enforce those rights.

**41** This conclusion is consistent with the modern approach to statutory interpretation. As this Court has repeatedly stated, the proper approach to statutory interpretation is that endorsed by the noted author E. A. Driedger, in *Construction of Statutes* (2nd ed. 1983), at p. 87: "the words of an Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme of the Act, the object of the Act, and the intention of Parliament". See for example *Rizzo & Rizzo Shoes Ltd. (Re)*, [1998] 1 S.C.R. 27, at para. 21. A consideration of these factors supports the proposition that under s. 48(12)(j) of the *LRA* an arbitrator has the power to enforce the substantive rights and obligations of human rights and other employment-related statutes that are, under the legal principles established in *McLeod*, part of the collective agreement.

(i) *The Plain and Ordinary Meaning of Section 48(12)(j) of the LRA*

**42** The primary factor that supports this conclusion is the very language of s. 48(12)(j), which provides that an arbitrator has the power "to interpret and apply human rights and other employment-related statutes, despite any conflict between those statutes and the terms of the collective agreement".

**43** The power to interpret and apply a particular statute would, in my view, ordinarily be understood to include the power to implement and enforce the substantive rights and obligations contained therein. The *Oxford English Dictionary* (2nd ed. 1989), vol. I, at p. 577, states that to "apply" means to "bring (a law, rule, test, principle, etc.) into contact with facts, to bring to bear practically, to put into practical

operation". Major J. suggests that my reasons do not respect the intention of the legislature. In my view, the use of the phrase "to interpret and apply human rights and other employment-related statutes" indicates that it was the legislature's intention that an arbitrator would have the power not only to enforce those rights and obligations that are expressly provided for in the collective agreement, but those that are provided for in human rights and employment-related statutes as well. My colleague's reasons leave unanswered the question of what result the legislature intended when it specifically incorporated the power of an arbitrator to interpret and apply human rights and other employment-related statutes into the *LRA*.

**44** The appellant submits that the power to interpret and apply human rights and other employment-related statutes arises only when there is a direct conflict between the collective agreement and the statute. Read grammatically, s. 48(12)(j) supports precisely the opposite conclusion. Section 48(12)(j) does not state that the power arises if, and only if, there is a conflict between the collective agreement and the employment-related statute, but that it arises <u>even if</u> there is a conflict between the agreement and the statute. The obvious implication is that a conflict between the collective agreement and an employment-related statute is not a condition precedent of the power to bring that statute into practical operation.

**45** Considered alone, the language of s. 48(12)(j) reinforces the principles discussed above, namely, that the right of an employer to manage operations and direct the work force is subject not only to the express provisions of the collective agreement, but also to its employees' statutory rights. For this to be the case, an arbitrator must have the power to implement and enforce the substantive rights and obligations of human rights and other employment-related statutes. Section 48(12)(j) does not displace or otherwise restrict the principles discussed above, but, rather, affirms that an arbitrator does, in fact, have the power to bring human rights and other employment-related statutes into practical operation. In any event, I am of the view that the inclusion of a management rights clause that is sufficiently broad to include the right of management to discharge a probationary employee for discriminatory reasons gives rise to a conflict between the statute and the collective agreement.

(ii) *The Scheme of the Act*

**46** The appellant's primary submission is that an arbitrator has the power to interpret and apply human rights and other employment-related statutes if, and only if, it already has been determined that the arbitrator has jurisdiction over the subject matter of the grievance. According to the appellant, an arbitrator's primary source of jurisdiction is s. 48(1), which states that each collective agreement shall provide for final and binding settlement by arbitration of a difference arising out of that agreement. Section 48(12)(j), on the other hand, sets out the powers that an arbitrator possesses once it already has been determined that a grievance is arbitrable. On this view, the power to interpret and apply other statutes is merely one among nine other incidental powers that an arbitrator may exercise for the purpose of resolving a difference over which she or he already has jurisdiction.

**47** To a certain extent, I would agree. Indeed, the structure of s. 48 does seem to suggest that an arbitrator is intended to interpret and apply human rights and other employment-related statutes for the purpose of resolving a dispute that is arbitrable. This understanding of s. 48(12)(j) is consistent with the language of its predecessor, s. 45(8)3 of the *Labour Relations Act*, R.S.O. 1990, c. L.2, which provided as follows:

> **45.** ...
>
> (8) An arbitrator or arbitration board shall make a final and conclusive settlement of the differences between the parties and, <u>for that purpose</u>, has the

following powers:

...

3. To interpret and apply the requirements of human rights and other employment-related statutes, despite any conflict between those requirements and the terms of the collective agreement. [Emphasis added.]

The inclusion of the phrase "for that purpose" provides support for the proposition that the legislature envisioned that a dispute must be arbitrable before an arbitrator obtains the power to interpret and apply human rights and other employment-related statutes.

**48** But even if it is true that a dispute must be arbitrable before an arbitrator obtains the power to interpret and apply the *Human Rights Code*, it does not thereby follow that an alleged contravention of an express provision of a collective agreement is a condition precedent of an arbitrator's authority to enforce the substantive rights and obligations of employment-related statutes. Under *McLeod*, the broad right of an employer to manage operations and direct the work force is subject not only to the express provisions of the collective agreement but also to the statutory rights of its employees. This means that the right of a probationary employee to equal treatment without discrimination is implicit in each collective agreement. This, in turn, means that the dismissal of an employee for discriminatory reasons is, in fact, an arbitrable difference, and that the arbitrator has the power to interpret and apply the substantive rights and obligations of the *Human Rights Code* for the purpose of resolving that difference.

**49** Consequently, it cannot be inferred from the scheme of the *LRA* that it was the legislature's intention to displace or otherwise restrict the legal principles enunciated in *McLeod*. The appellant's submissions in respect of the structure of s. 48 are consistent with the conclusion that the substantive rights and obligations of the *Human Rights Code* are implicit in each collective agreement over which an arbitrator has jurisdiction. If an arbitrator is to enforce an employer's obligation to exercise its management rights in accordance with the statutory provisions that are implicit in each collective agreement, the arbitrator must have the power to interpret and apply human rights and other employment-related statutes. Section 48(12)(j) confirms that an arbitrator does, in fact, have this right.

(iii) *Policy Considerations*

**50** In respect of policy considerations, I first note that granting arbitrators the authority to enforce the substantive rights and obligations of human rights and other employment-related statutes advances the stated purposes of the *LRA*, which include promoting the expeditious resolution of workplace disputes. As this Court has repeatedly recognized, the prompt, final and binding resolution of workplace disputes is of fundamental importance, both to the parties and to society as a whole. See for example *Heustis v. New Brunswick Electric Power Commission*, [1979] 2 S.C.R. 768, at p. 781; *Blanchard v. Control Data Canada Ltd.*, [1984] 2 S.C.R. 476, at p. 489; and *Toronto Board of Education, supra*, at para. 36. It is essential that there exist a means of providing speedy decisions by experts in the field who are sensitive to the workplace environment, and which can be considered by both sides to be final and binding.

**51** The grievance arbitration process is the means by which provincial governments have chosen to achieve this objective. As Professor P. Weiler puts it, grievance arbitration is both "an antidote to industrial unrest and ... an instrument of employment justice": *Reconcilable Differences: New Directions in Canadian Labour Law* (1980), at pp. 91-92. The primary advantage of the grievance arbitration process is that it provides for the prompt, informal and inexpensive resolution of workplace disputes by a tribunal that has substantial expertise in the resolution of such disputes. It has the advantage of both accessibility and expertise, each of which increases the likelihood that a just result will be obtained with

minimal disruption to the employer-employee relationship. Recognizing the authority of arbitrators to enforce an employee's statutory rights substantially advances the dual objectives of: (i) ensuring peace in industrial relations; and (ii) protecting employees from the misuse of managerial power.

**52** Granting arbitrators the authority to enforce the substantive rights and obligations of human rights and other employment-related statutes has the additional advantage of bolstering human rights protection. Major J. correctly observes that if the dispute is non-arbitrable, aggrieved employees have available the same mechanism for enforcing fundamental human rights as any other member of society: they may file a complaint before the Human Rights Commission. But the fact that there already exists a forum for the resolution of human rights disputes does not mean that granting arbitrators the authority to enforce the substantive rights and obligations of the *Human Rights Code* does not further bolster human rights protection. As discussed above, grievance arbitration has the advantage of both accessibility and expertise. It is a reasonable assumption that the availability of an accessible and inexpensive forum for the resolution of human rights disputes will increase the ability of aggrieved employees to assert their right to equal treatment without discrimination, and that this, in turn, will encourage compliance with the *Human Rights Code*.

**53** A countervailing consideration is the fact that the Human Rights Commission has greater expertise than grievance arbitrators in the resolution of human rights violations. In my view, any concerns in respect of this matter are outweighed by the significant benefits associated with the availability of an accessible and informal forum for the prompt resolution of allegations of human rights violations in the workplace. It is of great importance that such disputes are resolved quickly and in a manner that allows for a continuing relationship between the parties. Moreover, expertise is not static, but, rather, is something that develops as a tribunal grapples with issues on a repeated basis. The fact that the Human Rights Commission currently has greater expertise than the Board in respect of human rights violations is an insufficient basis on which to conclude that a grievance arbitrator ought not to have the power to enforce the rights and obligations of the *Human Rights Code*.

**54** Support for this conclusion can be found in the Ministry of Labour's 1991 discussion paper, *Proposed Reform of the Ontario Labour Relations Act*, in which the Minister proposed that all collective agreements should be deemed to include the employment-related prohibitions of the *Human Rights Code* (p. 42). This indicates that it is the government's view that grievance arbitrators already possess sufficient expertise to address allegations that an employer contravened the right of each employee to equal treatment without discrimination. Similarly, in its submissions before this Court, the intervener, Human Rights Commission, stated that it believes that the grievance arbitration process has an important role to play in the resolution of human rights issues. It did not intervene on the basis that arbitrators should not have the power to resolve human rights issues, but on the basis that arbitrators and the Board should have concurrent jurisdiction. This suggests that the Commission also is of the view that grievance arbitrators have sufficient expertise to hear alleged violations of the *Human Rights Code*.

(4) Conclusion

**55** For the foregoing reasons, the Board was correct to conclude that the substantive rights and obligations of the *Human Rights Code* are incorporated into each collective agreement over which an arbitrator has jurisdiction. Because of this interpretation, an alleged violation of the *Human Rights Code* constitutes an alleged violation of the collective agreement, and falls squarely within the Board's jurisdiction. Accordingly, there is no reason to interfere with the Board's finding that the subject matter of Ms. O'Brien's grievance is arbitrable. The Board's finding that the discriminatory discharge of a probationary employee is arbitrable is not patently unreasonable.

C. *The Court of Appeal's Application of the ESA*

**56** The foregoing analysis is sufficient to dispose of the appeal. The Board's finding that the subject matter of Ms. O'Brien's grievance is arbitrable was not patently unreasonable and should be upheld. However, even if there was no basis on which to conclude that the alleged violation of the *Human Rights Code* is arbitrable, I would still be of the opinion that the analysis furnished by the Court of Appeal would provide sufficient grounds to conclude that Ms. O'Brien's grievance is a proper subject of the arbitration process.

**57** In substantive terms, there is no doubt but that the application of ss. 44 and 64.5(1) of the *ESA* leads to the conclusion that the subject matter of Ms. O'Brien's grievance is arbitrable. Under s. 64.5(1), the terms and conditions of the *ESA* are enforceable against an employer as if they were part of the collective agreement. Under s. 44, an employer is prohibited from dismissing an employee because the employee intends to take or takes pregnancy leave. The joint effect of ss. 44 and 64.5(1) is that each collective agreement is deemed to contain a provision that prohibits the discharge of a probationary employee because she took or intends to take pregnancy leave. Thus, the subject matter of Ms. O'Brien's grievance clearly constitutes a dispute that arises under a collective agreement over which the Board has jurisdiction.

**58** However, the appellant raised a number of objections to the Court of Appeal's decision to resolve the matter with reference to ss. 44 and 64.5(1) of the *ESA*. For the reasons that follow, it is my view that these objections are insufficient to preclude the resolution of the dispute on this basis.

(1) Limitations on the Scope of Judicial Review

**59** The appellant's first objection is that the Court of Appeal exceeded its jurisdiction by considering an issue that was not raised at the initial hearing. According to the appellant, the finding that currently is under review is the Board's finding that s. 5(1) of the *Human Rights Code* is enforceable against the employer as if it was part of the collective agreement. On this view, the Court of Appeal had the authority to review the Board's finding that s. 5(1) of the *Human Rights Code* is enforceable against the employer, but did not have the authority to consider whether s. 44 of the *ESA* is enforceable against the employer. Although I do not disagree with the general principle that on judicial review a court is limited to reviewing the tribunal's decision, I do not agree with the appellant's characterization of the finding that currently is under review. As above, the finding under review is not the Board's finding that s. 5(1) of the *Human Rights Code* is enforceable against the employer, but its finding that Ms. O'Brien's grievance is arbitrable.

**60** In reviewing a decision on a standard of patent unreasonableness, the reviewing court must consider the decision-making process in its entirety, including the failure of the tribunal to consider all of the relevant factors and legal principles. This reflects the fact that a decision will be patently unreasonable if the tribunal reaches a particular conclusion on account of its failure to take into account legal principles or statutory provisions that clearly are relevant to the issue that must be resolved: *Suresh v. Canada (Minister of Citizenship and Immigration)*, [2002] 1 S.C.R. 3, 2002 SCC 1, at para. 29. Consequently, the mere fact that a board of arbitration has determined that a grievance is arbitrable on grounds that have no basis in law will not lead inexorably to the conclusion that the arbitration award must be quashed. If there are alternative and legally correct grounds that lead to the conclusion that the grievance is arbitrable, quashing the award without considering those grounds would be perverse.

**61** In this instance, once the Board concluded that the subject matter of the grievance was arbitrable on the basis that s. 5(1) of the *Human Rights Code* is incorporated into the collective agreement, it was, in effect, unnecessary for the Board to consider the possible impact of ss. 44 and 64.5(1) of the *ESA*. But if there had been no basis on which to conclude that s. 5(1) of the *Human Rights Code* is enforceable against the employer, the Board could not properly have concluded that the subject matter of Ms.

O'Brien's grievance was non-arbitrable without first considering the possible impact of ss. 44 and 64.5 (1) of the *ESA*. Thus, it was not improper for the Court of Appeal to take into account the fact that the substantive rights and obligations of the *ESA* are incorporated directly into each collective agreement. If the Court of Appeal had upheld the Divisional Court's decision to reverse the arbitration award without taking into account the potential impact of ss. 44 and 64.5(1) of the *ESA*, it would arguably have committed an error of law.

**62** However, even if the Court of Appeal could, in theory, resolve the matter on this basis, the appellant nonetheless submits that the *ESA* and the collective agreement contain procedural provisions that prevent the Union from litigating the matter on the basis that the alleged misconduct constitutes a violation of s. 44 of the *ESA*.

(2) Procedural Considerations

**63** The appellant's primary submission in respect of this argument is that the Union is statute-barred from relying on the *ESA*. Section 64.5(4) of the *ESA* states that:

> An employee to whom a collective agreement applies (including an employee who is not a member of the trade union) is bound by a decision of the trade union with respect to the enforcement of the Act under the collective agreement, including a decision not to seek the enforcement of the Act.

According to the appellant, s. 64.5(4) binds a union to a prior decision not to seek enforcement of the *ESA*. Under this view, the respondent Union is bound by its prior decision not to seek enforcement of s. 44 of the *ESA* at the initial hearing. However, this interpretation of s. 64.5(4) is inconsistent with both its words and its fundamental purpose.

**64** First, s. 64.5(4) clearly states that an employee is bound by a decision of the trade union with respect to the enforcement of the Act under the collective agreement. It does not, however, provide that the union is bound by a decision not to seek enforcement of the *ESA*. If the purpose of s. 64.5(4) was to bind a trade union to its prior decision not to seek enforcement of the *ESA*, one would have expected the legislature to have used language indicating as much. On its face, s. 64.5(4) is directed not at the Union, but rather at the individual employee; it has no bearing on the circumstances in which a union is permitted to seek enforcement of the Act.

**65** This interpretation of s. 64.5(4) is consistent not only with its words but also with its basic purpose, namely, to ensure that the union has sole carriage over employment standards issues that arise during the currency of a collective agreement. This accords with established principles governing labour-management relations. Section 64.5(2), for example, provides that an employee to whom a collective agreement applies is not entitled to file or maintain a complaint under the *ESA*. Section 64.5 (3), in turn, provides that notwithstanding subs. (2) the Director of Employment Standards may permit an employee to file or maintain a complaint under the Act if the Director considers it appropriate in the circumstances. Each subsection suggests that the default presumption is that the union must decide whether or not to pursue a particular grievance. Section 64.5(4) reinforces this principle by binding an employee to the decision of a union not to seek enforcement of the *ESA*. The purpose of the provision is not to bind a union to a prior decision not to pursue an *ESA* complaint, but, rather, to affirm the principle that an employee to whom a collective agreement applies is not entitled to file or maintain a complaint under the Act.

**66** Consequently, s. 64.5(4) has no effect in this appeal. This case does not involve an individual employee who seeks to file or to maintain a complaint under the *ESA* despite the fact that the Union has decided not to seek enforcement of her rights under the Act. As a result, it is not necessary to consider

the possibility that the Union has made a "decision", as the word is used in s. 64.5(4), not to seek enforcement of the *ESA*.

**67** In the alternative, the appellant submits that the Union's failure to comply with the procedural requirements of the collective agreement precludes it from seeking enforcement of s. 44 of the *ESA*. Under Article 8.06(a) of the agreement, a discharge grievance must set out the section of the collective agreement that is alleged to have been violated. Ms. O'Brien's initial grievance, however, alleged only that she had been discharged from her position "without justification" and that the decision was "arbitrary, discriminatory, in bad faith and unfair". The grievance did not allege that the employer had violated s. 44 of the *ESA*, or even that she had been discharged because she took pregnancy leave. In the appellant's submission, the Union's failure to allege that s. 44 of the *ESA* had been violated precludes it from subsequently raising s. 44 as a potential basis of liability.

**68** As a general rule, of course, it is important that the parties to a collective agreement comply with the procedural requirements set out therein. If a union intends to plead that the employer has breached the employee's statutory rights, it should, as a matter of general practice, specify the statutory provision that the employer is alleged to have breached. That said, it is important to acknowledge the general consensus among arbitrators that, to the greatest extent possible, a grievance should not be won or lost on the technicality of form, but on its merits. In *Re Blouin Drywall Contractors Ltd. and United Brotherhood of Carpenters and Joiners of America, Local 2486* (1975), 8 O.R. (2d) 103 (C.A.), at p. 108, for example, Brooke J.A. wrote as follows:

> Certainly, the board is bound by the grievance before it but the grievance should be liberally construed so that the real complaint is dealt with and the appropriate remedy provided to give effect to the agreement provisions and this whether by way of declaration of rights or duties, in order to provide benefits or performance of obligations or a monetary award required to restore one to the proper position he would have been in had the agreement been performed.

**69** This approach has been adopted by numerous arbitrators. In *Spruce Falls Inc. and I.W.A.-Canada, Local 2995 (Trudel) (Re)* (2002), 106 L.A.C. (4th) 41, at p. 61, the arbitrator observed that a "grievance must be construed so that the 'real complaint' is dealt with and an appropriate remedy is provided to bring resolution to the matters which have given rise to the grievance". In *Peel District School Board and O.P.S.T.F., District 19 (Havery) (Re)* (2000), 84 L.A.C. (4th) 289, the arbitrator rejected the employer's motion to dismiss on the basis that the employer suffered no prejudice as a consequence of the union's failure to specify the section of the collective agreement that was alleged to have been breached. See also *Re Harry Woods Transport Ltd. and Teamsters Union, Local 141* (1977), 15 L.A.C. (2d) 140; *Aro Canada Inc. and I.A.M., Re* (1988), 34 L.A.C. (3d) 255; and *Liquid Carbonic Inc. and U.S.W.A., Re* (1992), 25 L.A.C. (4th) 144. These cases reflect the view that procedural requirements should not be stringently enforced in those instances in which the employer suffers no prejudice. It is more important to resolve the factual dispute that gives rise to the grievance.

**70** In this case, the employer was aware from the outset that the essence of the grievance was that Ms. O'Brien was discharged as a consequence of taking maternity leave. Although the written grievance did not specify that Ms. O'Brien believed that she had been discharged because she took maternity leave, or that the alleged misconduct constituted a violation of s. 44 of the *ESA*, the employer was fully apprised that this was the factual basis of the grievance. Further, the appellant was provided with a fair opportunity to prepare and make submissions in respect of this matter prior to the Court of Appeal's determination that the Board was authorized to resolve the dispute with reference to s. 44 of the *ESA*. Considered against this backdrop, I agree with Morden J.A. that the employer suffered no prejudice as a consequence of the Court of Appeal's decision to resolve the matter with reference to s. 44 of the *ESA*.

**71** Thus, if it had been patently unreasonable for the Board of Arbitration to conclude that the grievance was arbitrable because it had the authority to enforce s. 5(1) of the *Human Rights Code* as if it were part of the collective agreement, I do not believe that it would have been improper for the Court of Appeal to conclude that the grievance was arbitrable on the basis that the alleged misconduct constituted a violation of s. 44 of the *ESA*. Construing Ms. O'Brien's allegation that the decision to discharge her was "arbitrary, discriminatory, in bad faith and unfair" as sufficiently broad to encompass the allegation that she was discharged because she took maternity leave ensures that the "real complaint" is dealt with and that the matter that gave rise to the grievance is adequately addressed.

VI. Disposition

**72** For the foregoing reasons, Ms. O'Brien's grievance is arbitrable. I would therefore dismiss the appeal with costs.

The reasons of Major and LeBel JJ. were delivered by

**73** MAJOR J. (dissenting):-- I respectfully disagree with the reasons of Iacobucci J.

**74** Are all employment and human rights statutes incorporated into every collective bargaining agreement? Collective agreements occupy an important role in Canadian management-union relations. As both parties are experienced in various components of labour law including grievance procedures, the courts should reluctantly interfere and only when necessary. In this case, there were alternatives available to the parties. They, having chosen one, should not have had it usurped by the Court of Appeal on its own initiative. Because I believe that courts should assume that parties may set out the limits of their agreements absent express or implied legislative override, and because the parties should be bound by the form and substance of the grievance they chose, I would allow the appeal.

**75** I agree with Iacobucci J.'s characterization of the factual background of this appeal. However, a brief review of some of the procedural history may help put these reasons in context.

I. Procedural Background

**76** In June 1998, Joanne O'Brien, a "counsellor/casual field worker" who had probationary employment status, was dismissed by the Parry Sound Social Services Administration Board. She grieved, making a generalized claim of discrimination under a collective bargaining agreement between Parry Sound and her Union, the Ontario Public Service Employees Union, Local 324 ("OPSEU"). Parry Sound argued that O'Brien was not entitled to arbitration because the collective agreement explicitly did not cover the dismissal of probationary employees. It also claimed that O'Brien, who had never mentioned the *Employment Standards Act*, R.S.O. 1990, c. E.14, in her grievance, had not met the procedural requirements set out by Article 8.06(a) of the collective agreement, which required her to state "the section or sections of the Agreement which are alleged to have been violated". Since s. 64.5(1) of that Act specifies that it is to be treated as part of the collective agreement, Parry Sound argued that the Act should have been raised. The Union replied that the grievance's broad reference to discrimination sufficed, since O'Brien was not relying upon any explicit section of the collective agreement, but was rather relying upon an implicit incorporation of the *Human Rights Code*, R.S.O. 1990, c. H.19.

**77** In February 1999, a board of arbitrators ruled that it was entitled to consider whether O'Brien had been a victim of discrimination under the *Human Rights Code*. In January 2000, the Ontario Superior Court of Justice (Divisional Court) granted Parry Sound's application for judicial review, ruling that since the agreement did not cover the dismissal of probationary employees, the board of arbitrators had

no jurisdiction to arbitrate the dispute. The Union appealed to the Ontario Court of Appeal.

**78** Several months after the hearing, and years after the Union had first brought the grievance on its chosen grounds, the Court of Appeal, *sua sponte*, sought submissions from the parties on a new issue: the applicability of the *Employment Standards Act*. In June 2001, the Court of Appeal held, on the basis of this novel argument, that the board of arbitration had jurisdiction over the grievance. In *obiter dicta*, it also hinted that it believed that the arbitrator may have also had jurisdiction through an implied incorporation of the *Human Rights Code*.

II. Issues

**79** Two issues arise in this dispute. Is the *Human Rights Code* incorporated by implication into all collective agreements entered into under the Ontario *Labour Relations Act, 1995*, S.O. 1995, c. 1, Sch. A? Was it proper for the Court of Appeal, *sua sponte*, to ignore the procedural requirements negotiated by the parties and raise the *Employment Standards Act* argument? I disagree with Iacobucci J.'s reasons, and would answer both questions in the negative.

**80** His reasons conclude that the *Human Rights Code* is implicitly incorporated into all collective agreements. I respectfully disagree. Unless the legislature passes legislation incorporating the substance of its statutes into collective agreements, it is to be assumed that unions and employers may define which employees and disputes are covered by a collective agreement and therefore have access to binding arbitration, as long as the agreement does not conflict with statute or public policy. Absent legislative action, courts should not on their own initiative interfere with the terms of a collective agreement.

**81** Iacobucci J.'s reasons also conclude that the *Employment Standards Act* may be applied against Parry Sound years after the initial grievance, the process of which had been negotiated and agreed to by the parties, because Parry Sound would suffer no prejudice. I respectfully disagree. Where the parties have negotiated procedural guarantees relating to the timeliness, form and specificity of grievances, courts should not interfere. OPSEU is a sophisticated party, and should be bound by its decision not to pursue an *Employment Standards Act* claim.

**82** O'Brien is not without a remedy. She may use the mechanisms carefully set out by the legislature to vindicate her human rights, and may bring her claim before the Human Rights Commission. This appeal is not one about public policy and human rights. It is about discerning the intent of the parties and the legislature on the appropriate forum for vindicating those rights.

III. Standard of Review

**83** I agree with Iacobucci J.'s treatment of the standard of review: on the question of whether the *Human Rights Code* is incorporated into each labour agreement, the arbitrator must be correct. But if the arbitrator is correct on this issue, then his overall decision is subject to reversal only if it is patently unreasonable.

IV. Is the *Human Rights Code* Incorporated Into All Collective Agreements?

A. *Intention of the Parties*

**84** Some disputes between an employer and an employee are not subject to arbitration; the *Labour Relations Act, 1995*, s. 48(1), states that all differences between the parties in the interpretation of a

collective agreement are to be arbitrated, "including any question as to whether a matter is arbitrable". It is permissible for a bargaining agreement simply to not cover certain decisions on matters such as worker training or pensions, or to restrict the scope of the working conditions applicable to some employees, such as temporary workers. An arbitrator would be obligated to conclude that such a dispute is not arbitrable.

**85** In the present appeal, the collective agreement does not extend to the grievances of probationary employees over discharge. As with all employees, the rights of probationary employees are determined by the collective agreement. One of the provisions of that agreement states that the right to grieve does not extend to probationary employees grieving discharge during the probationary period. Article 8.06(a) of the collective agreement states:

> Notwithstanding anything in this Agreement, a probationary employee may be discharged at the sole discretion of and for any reason satisfactory to the Employer and such action by the Employer is not subject to the grievance and arbitration procedures and does not constitute a difference between the parties.

This language, "difference between the parties", is a reference to the language in s. 48(1) of the *Labour Relations Act, 1995*, specifying that differences between the parties are to be arbitrated. The intention of the parties is clear: Parry Sound and OPSEU explicitly chose not to bring the discharge of probationary employees under the grievance procedures in their collective agreement. The contract is silent as to other rights the employee or the Union might invoke in order to challenge or remedy a discharge.

B. *Intention of the Legislature*

**86** Does the *Human Rights Code* give probationary employees grievance rights under the collective agreement despite the intention of the parties not to cover them? The heart of the answer to this issue lies in the correct interpretation of the short judgment in *McLeod v. Egan*, [1975] 1 S.C.R. 517.

**87** Iacobucci J. states that *McLeod, supra*, stands for the proposition that all employment-related statutes, including the *Human Rights Code*, are implicitly incorporated into every collective bargaining agreement, and that s. 48(12)(j) of the *Labour Relations Act, 1995* codified this common law understanding. Although I agree that the structure and language of s. 48(12)(j) suggest no legislative intent to alter the common law rule from *McLeod*, I take a different view as to what that rule is.

**88** *McLeod* involved a conflict between an earlier version of the *Employment Standards Act* and a collective agreement (*Employment Standards Act, 1968*, S.O. 1968, c. 35). The earlier Act required that an employee consent to overtime hours, but the collective agreement in *McLeod* gave the company the sole authority over operations generally, including the right to "schedule its operations or to extend, limit, curtail or reschedule its operations when in its sole discretion it may deem it advisable to do so" (p. 521). This Court held, at p. 523:

> Any provision of an agreement which purported to give to an employer an unqualified right to require working hours in excess of those [overtime] limits would be illegal, and the provisions ... of the collective agreement, which provided that certain management rights should remain vested in the Company, could not ... enable the Company to require overtime work in excess of those limits.

**89** Iacobucci J. derives from this case the proposition that "[a]s a practical matter, this means that the substantive rights and obligations of employment-related statutes are implicit in each collective agreement over which an arbitrator has jurisdiction" (para. 28). He later states that "a conflict between the collective agreement and an employment-related statute is not a condition precedent of the power to

bring that statute into practical operation" (para. 44), and concludes, therefore, that all statutory protections are arbitrable under any collective agreement, even if the agreement purports not to cover the dispute in question.

**90** I come to a different conclusion. In *McLeod*, the employer was relying upon the explicit language of the collective agreement, which gave it the sole discretion to set overtime hours. This discretion was in clear and direct opposition to the *Employment Standards Act* of the time. The *McLeod* proposition is more limited than suggested: *McLeod* concludes only that a union and an employer are restricted from making an agreement contrary to law. This rule is no more than a modern application of a long-standing rule of the common law of contracts: courts will not enforce contracts that are illegal or against public policy. See *Bank of Toronto v. Perkins* (1883), 8 S.C.R. 603, in which the Court refused to enforce a secured loan made in contravention of the *Banking Act*. Labour contracts are not exempt from this rule.

**91** Iacobucci J.'s reasons too broadly apply *McLeod* to the facts of this case. In *McLeod*, there was a broad management rights clause that was held to be in violation of employee statutory rights granted by the *Employment Standards Act*. Iacobucci J.'s reasons conclude that "[j]ust as the collective agreement in *McLeod* could not extend to the employer the right to require overtime in excess of 48 hours, the collective agreement in the current appeal cannot extend to the appellant the right to discharge an employee for discriminatory reasons" (para. 32).

**92** But here, the appellant does <u>not</u> point to Article 5.01, which purports to give management the power to discharge probationary employees for any reason. It points to Article 8.06(a), stating that such discharges are not covered by the agreement at all, that they are not "differences" as defined by the *Labour Relations Act, 1995*, and implying that they are therefore inarbitrable.

**93** This distinction is crucial. Under *McLeod*, the parties attempted to explicitly "contract around" the protections conferred by statute, which is clearly impermissible. Here, the parties simply chose not to come to agreement on certain kinds of disagreements, explicitly choosing to remove the arbitrator's jurisdiction. The common law rule that parties may not contract in contravention of public policy does <u>not</u> require parties to agree to arbitrate violations of statutory rights.

**94** Under this more restrained reading of *McLeod, supra*, explicit statutory directions override conflicting provisions of collective agreements, but they do not affect the parties' ability to define the limits of their agreement. Parties remain free to exclude certain classes of employees, such as probationary, part-time, or temporary employees, from some of the provisions of the agreement, just as they remain free to exclude certain kinds of disputes from the jurisdiction of the arbitrator. They do this by limiting the scope of the grievance procedure on some matters or acknowledging that a party retains the right to make a unilateral final decision on certain questions.

**95** Although these labour agreements are entered into under the collective bargaining framework established by the *Labour Relations Act, 1995*, they are essentially private contracts of significant public importance. The decision to inject legislative protections into these private contracts is a serious one, though clearly one within the powers of a legislature. A court should not lightly infer such intent. When the Ontario legislature wishes to insert such protections directly into collective bargaining agreements, it knows how to do so explicitly and clearly. For example, s. 64.5(1) of the *Employment Standards Act* reads:

> If an employer enters into a collective agreement, the Act is enforceable against the employer with respect to the following matters as if it were part of the collective agreement:
>
> 1. A contravention of or failure to comply with the Act that occurs when the

collective agreement is in force.

There is no equivalent provision in the *Human Rights Code*.

**96** Iacobucci J.'s reasons state that the legislature must have intended that s. 48(12)(j) grant arbitrators jurisdiction over claims based on statutory protections. But I believe that this provision, coming as it does at the end of a long list of uncontroversial arbitrator's powers (the power to compel document production, the power to fix dates for hearings, the power to summon witnesses, the power to administer oaths, the power to accept oral or written evidence, etc.), does no more than confirm the rule from *McLeod*. Arbitrators may not enforce any contract that violates public policy by "contracting around" the protections of statute. To read into this innocuous provision the extraordinary power to take jurisdiction of any claim based on statute, despite the plain wishes of the parties to the contract, is a subversion of the legislative intent. If the legislature wished to thus expand the power of arbitrators, it surely would have signalled its intent more clearly.

**97** It is not for the court but rather the legislature to decide that particular statutory protections are so important that they must be injected into every collective agreement. Iacobucci J.'s rather expansive holding stands upon an extension of a 30-year-old case and an inexplicable notion of public policy. It does not respect the intention of the parties and the legislature, and is inconsistent with the court leaving to the legislature the duty of implementing what I take to be new policy.

**98** A more focussed reading of *McLeod, supra*, serves the public interest. It allows employers and unions to craft the mutually beneficial agreements most appropriate to their circumstances, subject to explicit legislative direction. In this appeal, it gives Parry Sound the flexibility to hire probationary employees, allowing it to reserve the full panoply of employment benefits and guarantees for employees who have demonstrated their value.

**99** Human rights abuses will not go unchecked. Aggrieved employees will have available the same mechanisms for enforcing their human rights as any other member of society: they may file a complaint before the Human Rights Commission, as the employer urged and as the legislature intended.

**100** Collective agreements reflect the outcome of a sometimes difficult process of negotiation. The content of the agreement may reflect the acknowledgment of the union that it should not be called upon to deal with matters it is not equipped to deal with or that might cause conflicts within its membership. Where remedies are available elsewhere, the silence of the agreement may reflect the wishes of the union that those remedies be used in preference to the remedies available under the agreement. Silence in the agreement does not indicate a denial of a right or its remedies. On the other hand, overloading the grievance and arbitration procedure with issues the parties neither intended nor contemplated channelling there, may make labour arbitration anything but expeditious and cost-effective. The present case speaks for itself in this respect.

**101** O'Brien's dismissal is not arbitrable because her Union and her employer agreed not to cover the dismissal of probationary employees in their collective agreement, and the legislature did not intend to require that they do so. She must seek the vindication of her rights before the Human Rights Commission, as would any employee not covered by a collective agreement.

V. The Tardy *Employment Standards Act* Argument

**102** As Iacobucci J. notes, there is little question that had OPSEU, Local 324, brought a claim in the original instance under ss. 44 and 64.5(1) of the *Employment Standards Act*, the claim would have been arbitrable. However, Article 8.06(a) of the collective agreement clearly required the Union to state "the section or sections of the Agreement which are alleged to have been violated". OPSEU should therefore

have raised s. 44 of the *Employment Standards Act*, barring employment discrimination on the basis of "pregnancy leave", which the legislature has explicitly incorporated into all collective agreements via s. 64.5(1). This OPSEU chose not to do. Even if the failure to raise the *Employment Standards Act* might have been curable or seen as a simple procedural defect, the Union would at the very least have had the obligation to raise the matter at the arbitration stage.

**103** The Union chose not to raise the *Employment Standards Act* claim at four different stages:

(i) when it grieved in June 1998,
(ii) at arbitration in February 1999,
(iii) at its first appeal before the Ontario Superior Court of Justice (Divisional Court) in January 2000, and
(iv) at its second appeal before the Ontario Court of Appeal.

This clearly was a decision by the Union not to raise the *Employment Standards Act*. This decision rests with the Union and the employee. In the Court of Appeal, the employer should have been entitled to rely on this decision of the Union. In spite of the Union decision, the Court of Appeal raised the issue *sua sponte* months after the hearing, sought briefing, and decided the case based upon grounds never advanced in the grievance.

**104** OPSEU and Parry Sound, both sophisticated entities, negotiated an agreement calling for certain procedural formalities -- among them, that any grievance identify with specificity the section of the collective agreement alleged to have been violated. Furthermore, the *Employment Standards Act* makes clear that it is the union and not the individual who is to control the course of a grievance under the Act.

**105** Section 64.5(2) reads:

> An employee to whom a collective agreement applies ... is not entitled to file or maintain a complaint under the Act.

**106** Section 64.5(4) reads:

> An employee to whom a collective agreement applies ... is bound by a decision of the trade union with respect to the enforcement of the Act under the collective agreement, including a decision not to seek the enforcement of the Act.

**107** The Union and O'Brien should be bound by the specific claims they made and the manner in which they presented them. The Court of Appeal erred in raising this issue, not chosen by the parties.

VI. Conclusion

**108** O'Brien's *Human Rights Code* claim is not the subject of the agreement between her employer and her Union, and is therefore not arbitrable. To vindicate these rights, she must proceed before the Human Rights Commission.

**109** I would allow the appeal with costs.

**Solicitors:**

Solicitors for the appellant: Blake, Cassels & Graydon, Toronto.

Solicitor for the respondent: Ontario Public Service Employees Union, North York.

Solicitor for the intervener: Ontario Human Rights Commission, Toronto.

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# TAB 7

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# Sullivan on the Construction of Statutes

**Fifth Edition**

by

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## PART 1. GOVERNING PRINCIPLES

***Legislation is paramount.*** It follows from the principle of legislative sovereignty that validly enacted legislation is paramount over the common law.[4] Acting within its constitutionally defined jurisdiction, the legislature can change, add to or displace the common law as it thinks appropriate and the courts must give effect to that intention regardless of any reservations they might have concerning its wisdom. As stated by Martin J.A. in *Schiell v. Morrison*:

> It is true that the legislation is an encroachment on the common-law doctrine ... but if it is clear that it was the intention of the Legislature in passing a statute to abrogate the common law, it must give way, and the provisions of the statute must prevail.[5]

In so far as legislation comes into conflict with the common law, the legislation prevails.

***Presumption against changing the common law.*** Although legislation is paramount, it is presumed that legislatures respect the common law. It is also presumed that legislatures do not intend to interfere with common law rights, to oust the jurisdiction of common law courts, or generally to change the policy of the common law.[6] As explained in *Halsbury,* in a formulation adopted by many Canadian courts:

> Except in so far as they are clearly and unambiguously intended to do so, statutes should not be construed so as to make any alteration in the common law or to change any established principle of law.[7]

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[4] Common law in this context refers to all judge-made law, including equity. See, for example, *Buschau v. Rogers Communications Inc.*, [2006] S.C.J. No. 28, [2006] 1 S.C.R. 973 (S.C.C.), where a majority of the court found that the legislation under which the respondent's trust-based pension plan was established precluded the plan's beneficiaries from relying on the rule in *Saunders and Vautier* (1841), Cr. & Ph. 240, 41 E.R. 482 to prematurely end the trust. Historically, however, courts of equity treated statute law much the way they treated common law rules. If justice required it, they felt free to vary the effect of statutes through doctrines like part performance and clean hands. For an excellent discussion of this anomaly, see the judgment of Robertson J.A. in *Safeway Shouldering Ltd. v. Nackawic (Town)*, [2001] N.B.J. No. 63, at para. 37ff (N.B.C.A.).

[5] [1930] 2 W.W.R. 737, at 741 (Sask. C.A). See also *Friedmann Equity Developments Inc. v. Final Note Ltd.*, [2000] S.C.J. No. 37, [2000] 1 S.C.R. 842, at para. 38 (S.C.C.); *R. v. Mills*, [1999] S.C.J. No. 68, [1999] 3 S.C.R. 668, at para. 60 (S.C.C.); *Garland v. Consumers' Gas Co.*, [1998] S.C.J. No. 76, [1998] 3 S.C.R. 112, at para. 29, 51 (S.C.C.); *R. v. Corbett*, [1988] S.C.J. No. 40, [1988] 1 S.C.R. 670, at 700-01 (S.C.C.); *Attorney-General of Quebec v. Carrières Ste-Thérèse Ltée*, [1985] S.C.J. No. 37, [1985] 1 S.C.R. 831, at 607 (S.C.C.).

[6] For discussion of these presumptions, see *infra*, Chapter 16, at pp. 482-83, 485-87.

[7] 36 Hals., 3rd ed., p. 412, para. 625. See *A.G. (ex rel. Yorkshire Derwent Trust Ltd.) v. Brotherton*, [1992] 1 A.C. 425, at 439 (H.L.); *Zaidan Group Ltd. v. London (City)*, [1987] O.J. No. 270, 58 O.R. (2d) 667, at 674 (Ont. H.C.J.); affd [1988] O.J. No. 356, 64 O.R. (2d) 438 (Ont. H.C.J. (Div. Ct.)); revd [1990] O.J. No. 33, 71 O.R. (2d) 65 (Ont. C.A.); affd [1991] S.C.J. No.

These presumptions permit the courts to insist on precise and explicit direction from the legislature before accepting any change. The common law is thus shielded from inadvertent legislative encroachment.

***Area of law dealt with.*** The courts readily assume that reform legislation is meant to be assimililated into the existing body of common law.[8] This assumption is likely to apply to any legislation dealing with so-called "private" law — the law of contracts, torts and private property. Historically, the law governing these matters is rooted in the common law and still is closely associated with common law principles and values. In addition, certain types of law such as procedure and evidence are thought to be especially suited to the common law method of incremental development by judges. Because judges participate in the day to day operation of this law, they are well placed to assess its strengths and weaknesses and the likely impact of proposed changes.[9] Finally, certain matters are subject to the inherent jurisdiction of the courts. It is doubtful that legislatures could succeed in fully ousting this jurisdiction.

Conversely, when legislation is addressed to matters outside the traditional concerns of judge-made law, the courts readily concede the primacy of the legislature. This is so particularly when dealing with program legislation -- a statute-based social program, for example, or a comprehensive regulatory scheme. In interpreting such legislation, resort may be had to the common law, but only as needed to carry out the legislature's purpose and to ensure the effective operation of its scheme. This point was made by Lord Scarman in *Pioneer Aggregates (U.K.) Ltd. v. Secretary of State for the Environment*:

> Planning control is a creature of statute. ... It is a field of law in which the courts should not introduce principles or rules derived from private law unless it be expressly authorised by Parliament or necessary in order to give effect to the purpose of the legislation.[10]

When dealing with so-called public law regimes, the courts generally decline to revert to private law principles.

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92, [1991] 3 S.C.R. 593 (S.C.C.). See also the authorities mentioned in discussion of the presumption against legal change, Chapter 16, pp. 482-83.

8 For discussion of reform legislation and the distinction between reform and program legislation, see *supra*, Chapter 8, at pp. 261-263.

9 This point is made by Lord Donovan in *Myers v. D.P.P.*, [1965] A.C. 1001, at 1047 (H.L.): "The common law is moulded by the judges and it is still their province to adapt it from time to time so as to make it serve the interests of those it binds. Particularly is this so in the field of procedural law." This passage has been relied on by Canadian courts: see *R. v. Salituro*, [1991] S.C.J. No. 97, [1991] 3 S.C.R. 654, at para. 30 (S.C.C.), and the cases cited therein. See also *R. v. Corbett*, [1988] S.C.J. No. 40, [1988] 1 S.C.R. 670, at 729-36 (S.C.C.), where a magistrate of the court held that s. 12 of the *Canada Evidence Act*, permitting proof of prior corrections of witnesses to be adduced, left room for the exercise of judicial discretion to exclude such evidence: "[t]hat discretion ... exists at common law, being one of the fundamental postulates of the law of evidence", *per* La Forest J. (at 730-31).

10 [1985] A.C. 132, at 140 (H.L.). See discussion of program legislation in Chapter 8, pp. 262-63.

***Adequacy of the legislation.*** Arguably the most important factor in determining the relationship between legislation and the common law is the court's sense of what is needed to ensure a coherent and effective operation of the law. When legislation is silent on a particular matter or does not yield a coherent outcome, the courts look to the common law for a solution. Resorting to the common law in such circumstances is appropriate unless there is reason to believe that the legislature intended to displace the common law.

In *R. v. Nette*,[11] for example, the issue before the Supreme Court of Canada was the test of causation applicable to second degree murder. Because this issue was not explicitly addressed in the *Criminal Code* provisions defining murder and degrees of murder, the Supreme Court of Canada fell back on the common law. As Arbour J. explained:

> The law of causation is in large part judicially developed, but is also expressed, directly or indirectly, in provisions of the *Criminal Code*. For example, ... ss. 222(5)(c) and 222(5)(d) provide that a person commits culpable homicide where he causes the death of a person by causing that person, by threats, fear of violence or by deception, to do anything that causes his death or by wilfully frightening a child or sick person. These statutory provisions and others like them in the Code preempt any speculation as to whether the act of the accused would be seen as too remote... *Where the factual situation does not fall within one of the statutory rules of causation in the Code, the common law general principles of criminal law apply to resolve any causation issues that may arise.*[12]
>
> [Author's emphasis]

A more striking example of resort to the common law occurred in *R. v. Jobidon*,[13] where the offence of assault as set out in the *Criminal Code* was supplemented by adding common law qualifications to the statutory definition. Under s. 244(1) of the Code, assault was defined as the intentional application of force to a person without that person's consent. Under s. 244(3), consent was deemed to be withheld if a person submitted to force for any of four reasons listed in the provision. This list was a partial codification of the common law limitations on consent. Given the legislature's express adoption of some of these limitations and its silence with respect to the others, the court might well have concluded that limitations not mentioned in the section were impliedly excluded. However, this outcome was unacceptable to the Court. As Zuber J.A. wrote:

> In my respectful view, the concept of consent as it appears in s. 244 of the *Criminal Code* should be construed subject to the same limitations as are imposed by the common law. There are good reasons for so doing. First, this interpretation conforms with the traditional understanding of the law which existed for a very long time prior to 1972. Secondly, this interpretation is in accord with

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[11] [2001] S.C.J. No. 75, [2001] 3 S.C.R. 488 (S.C.C.).

[12] *Ibid.*, at para. 48.

[13] [1988] O.J. No. 1856, 45 C.C.C. (3d) 176 (Ont. C.A.); affd [1991] S.C.J. No. 65, [1991] 2 S.C.R. 714 (3d) 454 (S.C.C.).

> the over-all purpose of the *Criminal Code*, *i.e.*, the protection of the public and keeping the peace. Lastly, this interpretation accords with sound policy. The so-called consents to fight are often more apparent than real and are obtained in an atmosphere where reason, good sense and even sobriety are absent.... To interpret the *Criminal Code* otherwise would continue to legitimize the uncivilized brawling which, because of *Dix*, is not the subject of the criminal sanction.[14]

Notice that the effect of resorting to the common law in this case was to redefine the offence so as to enlarge its scope. Sopinka J., dissenting in the Supreme Court of Canada, made this point when he wrote:

> ... In Canada, the criminal law has been codified and the judiciary is constrained by the wording of sections defining criminal offences. ...
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> ... The effect of my colleague's approach is to create an offence where one does not exist under the terms of the *Code* by application of the common law.[15]

## PART 2. USE OF COMMON LAW IN INTERPRETATION

### RELIANCE ON COMMON LAW TO INTERPRET STATUTORY LANGUAGE

***Incorporation of common law concepts or terms.*** When used in legislation, common law terms and concepts are presumed to retain their common law meaning.[16] In *R. v. Holmes*,[17] for example, the Supreme Court of Canada was concerned with the scope of the word "excuse" in the phrase "without lawful excuse" appearing in several provisions of the *Criminal Code*. Although the majority adopted a restrictive reading of this phrase, Dickson C.J. wrote:

> There is no doubt that Parliament can redefine the meaning of "excuse"... The important point is that Parliament should give some indication, express or implied, that it has changed the meaning of "excuse" when it uses it in a statute. Otherwise, the word will be understood to have the meaning of "excuse" under the common law...[18]

For the presumption to apply it is unnecessary that the legislation exactly reproduce the common law terminology. So long as it uses language that is apt to refer to the common law principle or concept, the presumption applies. This

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14 *Ibid.*, at 184; affd [1991] S.C.J. No. 65, [1991] 2 S.C.R. 714 (S.C.C.). See especially 475-80, 491-94.

15 *Ibid.*, at paras. 144-45. See also *R. v. Di Pietro*, [1986] S.C.J. No. 15, [1986] 1 S.C.R. 250 (S.C.C.). See also Chapter 6, pp. 191-92.

16 This presumption sometimes clashes with the presumption in favour of ordinary, non-technical meaning. See Chapter 3.

17 [1988] S.C.J. No. 39, [1988] 1 S.C.R. 914 (S.C.C.).

18 *Ibid.*, at para. 25. See also *Blank v. Canada (Minister of Justice)*, [2006] S.C.J. No. 39, [2006] 2 S.C.R. 319, at paras. 4, 69 (S.C.C.); *Payne v. Alb*, [1999] O.J. No. 1954, 44 O.R. (3d) 598, at 604-05 (Ont. C.A.); *Streeting v. Canada (Minister of Employment & Immigration)*, [1988] F.C.J. No. 127, 49 D.L.R. (4th) 145, at 151-52 (F.C.T.D.).

point is made by the Supreme Court of Canada in *Woelk v. Halvorson*,[19] interpreting Alberta's *Domestic Relations Act*. Section 35(1) provided that where physical harm inflicted on a married person by a tortfeasor has deprived the married person's spouse "of the society and comfort of that married person", an action in damages could be brought against the tortfeasor in respect of the deprivation. McIntyre J. wrote:

> The wife's claim at trial, while statutory and framed under s. 35(1) of the *Domestic Relations Act* of Alberta, amounts to a claim for damages for the loss or impairment of *consortium*. I observe that the section refers to the deprivation of the comfort and society of the spouse. While those words, it was said, are not exhaustive of all the elements attributed to the older expression "*consortium*" in the common law authorities, in my opinion they do refer to that concept and, when used in a statute dealing with domestic relations, the words are broad enough on their ordinary meaning to embrace the historic concept of *consortium*.[20]

When legislation does not exactly reproduce existing common law terminology, and even when it does, the court must consider whether and to what extent the legislature intended to codify or to modify *the* common law concept. In *Prebushewski v. Dodge City Auto (1984) Ltd.*,[21] for example, the Supreme Court of Canada had to determine whether the reference to exemplary damages in s. 65(1) of Ontario's *Consumer Protection Act* was meant to create a new remedy or merely codify the common law. Subsection 65(1) provided:

> 65(1) In addition to any other remedy provided by this Part or any other law in force in the province, a consumer …may recover exemplary damages from any manufacturer, retail seller or warrantor who has committed a wilful violation of this Part.

In concluding that the section was meant to create a new remedy, Abella J. wrote:

> At common law, exemplary or punitive damages are awarded only in exceptional cases … of "malicious, oppressive and high-handed" conduct that "offends the court's sense of decency". …
>
> In my view a different test for exemplary damages is anticipated by s. 65(1). The language of s. 65(1) is clear and unambiguous: once a wilful - or deliberate — violation has been found, the trial judge has a discretion to award exemplary damages. Had the legislature intended that the common law — and more exacting — test apply, it could easily have used words affiliated with the traditional approach to exemplary damages, such as "malicious" or "oppressive". By designating instead that "wilful" violations of the Act are sufficient to trigger a judge's

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19 [1980] S.C.J. No. 82, [1980] 2 S.C.R. 430 (S.C.C.).

20 *Ibid.*, at 390.

21 [2005] S.C.J. No. 10, [2005] 1 S.C.R. 649 (S.C.C.).

> discretion, the legislature has signalled an intention to lower the threshold and grant easier access to the remedy of exemplary damages.[22]

Abella J. went on to point out that this interpretation was in keeping with the purpose of the provision and the scheme of the Act.

***Provisions that codify the common law.*** Canadian courts outside Quebec generally use the terms "codify" and "codification" to refer to legislative provisions that reproduce the common law without changing it. When a common law rule or principle is "codified" in this sense, it is stated in a fixed statutory form while its substance remains the same. In interpreting a codified rule or principle, the courts look to the common law for clarification. They therefore look to pre-enactment cases in the enacting jurisdiction and to cases in other common law jurisdictions as well.

In *Waldick v. Malcolm*,[23] for example, the Supreme Court of Canada had to interpret Ontario's *Occupier's Liability Act*. Section 3(1) of the Act provided that an occupier owes a duty of care to persons entering the premises. Section 4(1) provided that the duty "does not apply in respect of risks willingly assumed" by persons entering the premises. One of the issues dealt with in the case was the relation of the defence created by s. 4(1) to the common law defence of *volenti non fit injuria*. The Court concluded that the legislation codified rather than modified the common law doctrine. Iacobucci J. wrote:

> I have no doubt that s. 4(1) of the Act was intended to embody and preserve the *volenti* doctrine. This can be seen by looking at the statutory scheme that is imposed by the Act as a whole. It is clear the intention of the Act was to replace, refine and harmonize the common law duty of care owed by occupiers of premises to visitors on those premises. That much seems evident from the wording of s. 2 of the Act:
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>> 2. ... the provisions of this Act apply in place of the rules of the common law that determine the care that the occupier of premises at common law is required to show ... to persons entering on the premises....
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> I am of the view that the Act was not intended to effect a wholesale displacement of the common law defences to liability, and it is significant that no mention is made of common law defences in s. 2. Reinforcement of this view is found when one asks why this area of law should entail a defence other than *volenti* which is applicable to negligence actions generally. ...[24]

The Court here relied on an implied exclusion argument as well as the norm of uniformity to conclude that s. 4(1) was properly understood to be a codification. Having reached that conclusion, the Court then turned to common law cases, both Canadian and British, to establish the content of the doctrine.

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22 *Ibid.*, at paras. 24-25.

23 [1991] S.C.J. No. 55, [1991] 2 S.C.R. 456 (S.C.C.).

24 *Ibid.*, at paras. 40-41. Emphasis in original. See also *Wolfe Island (Township) v. Ontario (Ministry of the Environment)*, [1995] O.J. No. 1537, 23 O.R. (3d) 737 (Ont. C.A.).

***Provisions that modify the common law.*** When legislation is enacted to change the common law, courts are careful not to undermine the legislature's purpose by re-introducing common law rules or principles through interpretation. This point is made in the *Woelk* case. As explained above, *Woelk* dealt with the action for loss of *consortium* created by s. 35(1) of Alberta's *Domestic Relations Act*.[25] At common law this action could be brought only by husbands and was regarded by the courts as ill-conceived and anomalous. In responding to the new legislation, McIntyre J. emphasized the Court's obligation to give full effect to the legislature's policy of change:

> ... the enactment of s. 35 has extended the right of action for a loss of *consortium* to wives and, by its statutory pronouncement, has created a new cause of action which must be approached, freed from the limitations imposed by the earlier decisions in the common law. In my opinion, it is not open to the Court to treat the new cause of action as trivial and deserving of only token awards. It is not open to the Courts to consider that the Legislature of Alberta, in passing s. 35, intended to preserve the old jurisprudence... It is my view that, the Legislature having created the right of the wife to damages and having omitted any restriction on damage awards, the Courts must endeavour to assess the damages realistically, according to the evidence in each case.[26]

As the *Woelk* and *Waldick* cases emphasize, when legislation is enacted to reform the common law, it is important to analyze carefully the purpose and scope of the intended reform. Because the legislation is meant to operate within an existing framework of established concepts and principles, it must be interpreted with those concepts and principles in mind. But in so far as the legislation is designed to effect specific changes, the weight of past understandings must not be allowed to defeat that purpose.

This point is emphasized by the Supreme Court of Canada in *Re Giffen*,[27] where the issue was the effect of s. 20(a) of British Columbia's *Personal Property Security Act* (the PPSA). It provided that a security interest in property is not effective against a trustee in bankruptcy unless the security interest was perfected at the date of the bankruptcy. In this case, title to a car leased by the bankrupt with an option to purchase had remained in the lessor creating a security interest within the meaning of the *PPSA*. However, the lessor had never perfected its interest. The car was sold and both the lessor and the trustee in bankruptcy claimed the proceeds. Relying on common law principle, the Court of Appeal held that the trustee in bankruptcy could acquire no better title to the car than the lessee herself enjoyed. On this analysis, the lessor was entitled to the proceeds. The Supreme Court of Canada disagreed. As Iacobucci J. wrote:

> Simply put, the property rights of persons subject to provincial legislation are what the legislature determines them to be. While a statutory definition of rights

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25 See *supra* note 19, at 434.
26 See *Woelk v. Halvorson*, *supra* note 19, at 391.
27 [1998] S.C.J. No. 11, [1998] 1 S.C.R. 91 (S.C.C.).

> may incorporate common law concepts in whole or in part, it is open to the legislature to redefine or revise those concepts as may be required to meet the objectives of its legislation. This was done in the provincial PPSAs, which implement a new conceptual approach to the definition and assertion of rights in and to personal property falling within their scope. The priority and realization provisions of the Acts revolve around the central statutory concept of "security interest". The rights of parties to a transaction that creates a security interest are explicitly not dependent upon either the form of the transaction or upon traditional questions of title. Rather, they are defined by the Act itself.[28]

The Court conceded that at common law it is well established that a trustee in bankruptcy cannot obtain an interest in property superior to the bankrupt's. But the *PPSA* deliberately modified the common law: "the principle that a trustee in bankruptcy cannot obtain greater rights to the property than the bankrupt had has been modified through the policy choices of the legislatures represented in s. 20(b)(i) of the *PPSA*, and its equivalents in other provinces."[29]

***Interpreting an "exhaustive code".*** Canadian courts outside Quebec use the term "code", or more often "exhaustive code", to refer to any legislation that purports to set out a complete and comprehensive statement of the law governing a matter.[30] The key feature of a code is that it is meant to offer an exhaustive account of the law; it occupies the field in effect, displacing existing common law and cutting off further common law evolution. Once a code is in place, subsequent elaboration of the law dealt with in the code is carried out within its institutional framework and is governed by its principles and policies.

When a code is enacted in an area where there is an existing body of judge-made law, the courts face a delicate task. Obviously the common law cases are an important source of law and should be looked to for clarification. But a code is not necessarily a codification of existing law. The courts must be sensitive to the ways in which a code is meant to modify existing law. They must also appreciate that the meaning or impact of existing rules or concepts may be affected by their integration into a coherent, self-contained scheme or by their interaction with new rules. For these reasons, the courts have been reluctant to apply the presumption against changing the common law to legislation that is meant to be a code. Lord Hershell wrote in *Bank of England v. Vagliano Brothers*:

> ... the proper way to deal with such a statute as the *Bills of Exchange Act*, which was intended to be a code of the law relating to negotiable instruments ... is in the first instance to examine the language of the statute and to ask what is its natural meaning, uninfluenced by any considerations derived from the previous state of the law, and not to start with inquiring how the law previously stood, and then,

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[28] *Ibid.*, at para. 26.

[29] *Ibid.*, at para. 56. See also *Friedmann Equity Developments Inc. v. Final Note Ltd.*, [2000] S.C.J. No. 37, [2000] 1 S.C.R. 842, at para. 38 (S.C.C.); *Garland v. Consumer's Gas Co.*, [1998] S.C.J. No. 76, [1998] 3 S.C.R. 112, at paras. 29, 51 (S.C.C.).

[30] For discussion of the distinctive character of civil law codes, see P.-A. Côté, *The Interpretation of Legislation in Canada*, 3rd ed. (Scarborough: Carswell, 2000) at pp. 26ff.

> assuming that it was probably intended to leave it unaltered, to see if the words of the enactment will bear an intepretation in conformity with this view.
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> ... I am of course far from asserting that resort may never be had to the previous state of the law for the purpose of aiding in the construction of the provisions of the code. If, for example, a provision be of doubtful import, such resort would be perfectly legitimate.... What, however, I am venturing to insist upon is, that the first step taken should be to interpret the language of the statute, and that an appeal to earlier decisions can only be justified on some special ground.[31]

In interpreting a code, concern for the internal coherence of the statute takes precedence over the presumption against changing the common law. As much as possible, the policies and values relied on in interpretation are derived from the code itself rather than the common law. However, in so far as the code incorporates common law terms and concepts, interpreters must rely on the common law to interpret them.

## RELIANCE ON COMMON LAW TO SUPPLEMENT LEGISLATION

***Introduction.*** The previous section looked at reliance on the common law to help understand the meaning of statutory language. This section looks at reliance on the common law to supplement legislation. The issue of supplementation arises both when there is a gap in the legislative scheme[32] and when there is overlap between legislation and the common law such that both may apply to a particular set of facts. Sometimes the gap or overlap relates to substantive law and the concern is whether the enactment of one or more legislative rules was meant to displace existing common law rules. Sometimes the gap or overlap relates to remedies or jurisdiction and the concern is whether a person is precluded from invoking existing common law remedies or bringing an action before the ordinary courts. Although rules, remedies and jurisdiction are distinct concerns, in each case the fundamental question is the same: is it permissible to supplement the legislation by resorting to the common law?

The courts generally pose this question by asking whether the legislation to be interpreted is an "exhaustive code". Since codes are meant to be the sole source of law governing an area, resort to the common law to supplement a code is impermissible.

Although widely used, this approach has a number of problems. First, courts often disagree on whether legislation should be labelled a code in the relevant sense, and in many cases their determination appears to be driven by the preferred outcome. That is, if the court thinks resort to the common law would be inappropriate, the legislation is labeled a code but otherwise not. In such cases,

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[31] [1891] A.C. 107, at 144-45 (H.L.). See also *MacLeod Savings & Credit Union Ltd. v. Perrett* [1981] S.C.J. No. 10, [1981] 1 S.C.R. 78, at 197 (S.C.C.).

[32] For discussion of legislative gaps and reliance on common law to fill them, see Chapter 6, pp. 191-92.

labeling legislation a "code" is a way of expressing the conclusion that the legislation in question is meant to provide an exclusive regulation of the problem.

A second problem with this approach is lack of flexibility. When legislation is labeled a code, the implication is that resort to the common law is precluded in all cases for all purposes. When the label is applied to a single, narrowly focused provision, this rigidity is unlikely to cause problems. When it is applied to an entire statute, however, it is highly problematic because it forces interpreters to adopt an all-or-nothing approach. The statute either is an exhaustive code, in which case it cannot be supplemented, or is not an exhaustive code, in which case interpreters can take full advantage of supplementary common law.

A better approach is suggested by L'Heureux-Dubé J. in *Gendron v. Supply & Services Union of the Public Service Alliance of Canada, Local 50057*.[33] The issue in *Gendron* was whether an employee could bring an action against his union for breach of the common law duty of fair representation. The Court ruled that because the duty of fair representation had been incorporated into the *Canada Labour Code*, resort to the common law was no longer possible. L'Heureux-Dubé J. wrote:

> In reviewing the legislation it becomes clear that, *at least as regards the duty of fair representation*, Parliament has enacted a comprehensive, exclusive code. An overview of the Code puts the statutory duty of fair representation in its proper context, that of a complete and comprehensive scheme that both supplies the duty and provides the necessary adjudicative machinery such that resort to the common law is duplicative in any situation where the statute applies. While not determinative in itself, this is in my view a strong indication of Parliament's intention that the Code occupy the whole field *in terms of a determination of whether or not a union has acted fairly*.[34]
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> [Author's emphasis]

L'Heureux-Dubé J. here emphasizes the comprehensive and exclusive character of the Code for the specific purpose of providing a remedy for breach of the duty of fair representation. For some other purpose, resort to the common law might well be apt:

> [A] different conclusion may be warranted in a case where the statute is silent or by its terms cannot apply.[35]

The real question for the Court, then, is not so much whether a statute is a code but whether resort to the common law in this case for this purpose is permissible. As McLachlin J. points out in *Brotherhood of Maintenance of Way Employees Canadian Pacific System Federation v. Canadian Pacific Ltd.*, "no matter how comprehensive a statutory scheme ... may be, the possibility always

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33 [1990] S.C.J. No. 55, 1 S.C.R. 1298 (S.C.C.).

34 *Ibid.*, at para. 42.

35 *Ibid.*, at para. 46.

remains that events will produce a difficulty which the scheme has not foreseen."[36]

***Considerations governing resort to common law.*** In deciding whether resort to the common law is permissible to supplement a statutory scheme, the starting point is the presumption against changing the common law. In the absence of conflict or a reason to believe that the common law has been deliberately excluded, it continues to apply. This may give parties a choice of rules to rely on, and in some cases a choice of remedies or courts. Just as overlap is presumed when two statutory provisions apply to the same facts, so is overlap presumed when both statute and common law apply to the same facts.[37] In both cases, the presumption is rebutted in one of two two ways: by conflict between the overlapping laws or by evidence that the legislature intended its law, or some aspect of it, to be an exhaustive code.

The intent to create an exclusive code may be expressly stated in the legislation or it may be implied from reading the legislation in its relevant context. When an enactment duplicates the common law, offers a comprehensive regulation of a matter or implements a specific legislative policy choice, the courts are likely to infer that it was meant to be exhaustive. This inference may also be based on implied exclusion, the presumption against tautology or the unsatisfactory state of the common law.

The presumption of overlap with the common law is unlikely to be rebutted when the applicable legislation fails to offer an adequate resolution of the problem facing the court. This is a particularly important factor when it comes to remedies. If legislation confers rights on persons but does not provide an adequate means of redress for violation of those rights, the natural response is to resort to common law courts and remedies. As the courts frequently observe, there is no right without a remedy.

These considerations are examined in more detail below.

***Express indication of legislative intent.*** Sometimes the intended relationship between legislation and the common law is expressly set out in the enactment. Such expressions of legislative intent may be found in preambles or titles as well as privative clauses and other declaratory provisions. Section 69 of Ontario's *Family Law Reform Act*, for example, abolished a number of specific common law causes of action relating to family relationships. This obviously precluded resort to the actions that were expressly mentioned in the section. Section 72 of Ontario's *Personal Property Security Act*, introduced in 1990, was drafted in the following terms:

> 72. Except in so far as they are inconsistent with the express provisions of this Act, the principles of law and equity, including the law merchant, the law relating to capacity to contract, principal and agent, estoppel, fraud, misrepresenta-

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36 [1996] S.C.J. No. 42, [1996] 2 S.C.R. 495, at para. 8 (S.C.C.).

37 For discussion of the presumption of overlap, see Chapter 10, pp. 328-29.

tion, duress, coercion, mistake and other validating or invalidating rules of law, shall supplement this Act and shall continue to apply.

This provision makes it clear that the *PPSA* is to be supplemented by the common law.

***Legislation offers comprehensive scheme.*** Resort to the common law is considered inappropriate when the legislation to be applied is broad and detailed enough to offer a comprehensive regulation of the matter in question. This is not to say that the Act as a whole necessarily amounts to a comprehensive code, but rather that the matter in question is dealt with by the legislature in a comprehensive fashion. It could be dealt with in part of a statute, in more than one statute, or in statute law supplemented by regulation. In so far as the legislation is comprehensive, it displaces the common law.

Legislation is considered comprehensive when it appears that every aspect of a matter, or every possible response to a matter, has been addressed by the legislature. The legislative response may take the form of rules set out in the statute itself or alternatively the statute may establish institutions or offices whose job it is to establish, administer and enforce a regulatory program.

In *Seneca College v. Bhadauria*,[38] for example, the issue was whether a victim of discrimination was limited to her recourses under the Ontario *Human Rights Code* or could bring a common law action for damages before the ordinary courts. Speaking for the Supreme Court of Canada, Laskin C.J. noted the comprehensive character of the Code on the matter of remedies:

> ... the enforcement scheme under the *Ontario Human Rights Code* ranges from administrative enforcement through complaint and settlement procedures to adjudicative or quasi-adjudicative enforcement by boards of inquiry. The boards are invested with a wide range of remedial authority including the award of compensation (damages in effect), and to [sic] full curial enforcement by wide rights of appeal which, potentially, could bring cases under the Code to this Court.[39]

Given the elaborate character of the scheme, and its broad scope, Laskin C.J. concluded that the legislation was intended to offer an exhaustive code of anti-discrimination remedies. He concluded with the following words:

> The view taken by the Ontario Court of Appeal ... may be commended as an attempt to advance the common law. In my opinion, however, this is foreclosed by the legislative initiative which overtook the existing common law in Ontario and

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38 [1981] S.C.J. No. 76, [1981] 2 S.C.R. 181 (S.C.C.). See also *St. Anne Nackawic Pulp & Paper v. Canadian Paperworkers Union, Local 219*, [1986] S.C.J. No. 34, [1986] 1 S.C.R. 704, at 11-12 (S.C.C.); *McBride v. Comfort Living Housing Co-op. Ltd.*, [1992] O.J. No. 260, 7 O.R. (3d) 394, at 400 (Ont. C.A.).

39 *Ibid.*, at 194.

> established a different regime which does not exclude the Courts but rather makes them part of the enforcement machinery under the Code.[40]

To permit a common law action in these circumstances would defeat the apparent intention of the legislature and would risk disrupting the statutory enforcement scheme.

A similar analysis was adopted by the Supreme Court of Canada in *Regina Police Assn. Inc. v. Regina (City) Board of Police Commissioners*.[41] In that case, a union filed a grievance on behalf of a police officer who resigned from the force to avoid a disciplinary action and then sought reinstatement. The arbitrator refused jurisdiction on the ground that disputes concerning the discipline and dismissal of police officers came within the jurisdiction of the tribunals established by Saskatchewan's *Police Act, 1990*, and that jurisdiction was exclusive. The Supreme Court of Canada agreed. Bastarache J. wrote:

> Here, the legislature has shown its intention to have all matters relating to discipline governed by *The Police Act* and Regulations. It has attempted to provide a comprehensive scheme for both the investigation and adjudication of such disputes. As a result, we must avoid formalistic interpretations of the provisions that would deny the Commission jurisdiction where it was clearly the intention of the legislature that the Commission hear the dispute.[42]
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> ...
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> There is a well-founded public policy reflected in the comprehensive legislative scheme, namely that police boards shall have the exclusive responsibility for maintaining an efficient police force in the community. It is consistent with this well-founded public policy that the Comission hear and decide those disciplinary disputes which expressly or impliedly arise from the statutory scheme.[43]

In *Gladstone v. Canada (Attorney General)*,[44] the "exhaustive code" consisted of 11 sections of the *Fisheries Act* set out under the heading "Disposition of Things Seized". Since these sections did not provide for the payment of interest on proceeds held by the Crown, the respondent sought to rely on the doctrine of unjust enrichment to supplement the statute. Major J. wrote:

> I conclude that, for the purposes of this appeal, the *Fisheries Act* constitutes a complete code dealing with the return of seized property....
>
> It is apparent that the *Fisheries Act* creates a comprehensive framework for dealing with issues arising from seizure. For example, it provides for the detention of things seized (s. 71(1)). It also provides for the return of things seized if security is given (s. 71(2)) or if proceedings are not instituted (s. 71(3)). Other provisions deal specifically with fish. Section 73.2 provides that, at the time of

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40 *Ibid.* Although Laskin C.J.'s judgment has been widely criticized, at the time it was written there was no reason to anticipate the inadequacy of the legislature approach set out in the Code.

41 [2000] S.C.J. No. 15, [2000] 1 S.C.R. 360 (S.C.C.).

42 *Ibid.*, at para. 34.

43 *Ibid.*, at para. 38.

44 [2005] S.C.J. No. 20, [2005] 1 S.C.R. 325 (S.C.C.).

seizure, a fishery officer may return to the water any fish that the officer believes to be alive. Section 70(3) provides that if a fishery officer has seized fish, he or she may dispose of it in any manner considered appropriate.

At issue in this appeal is the interpretation of s. 73.1. It provides that any fish, thing, or proceeds realized that are not forfeited to Her Majesty are to be delivered to the person from whom the fish or thing was seized. This is clear. Section 71.1(2) contemplates the payment of interest when an amount is due to Her Majesty. (See also ss. 79.4(1) and 79.4(3)). However, there is no provision for interest if the payment is going the other way.

... This code imposes no obligation on the Crown to pay interest or any other amount in addition to what is set out in s. 73.1. The plain meaning of this statutory provision is clear. This may seem unfair given that the proceeds in the case at bar were held for a number of years. If so, it is for Parliament to correct it.[45]

Once the evidence of intention to create a complete code was accepted by the court, resort to the common law was precluded.

***Legislation implements specific policy choice.*** Resort to the common law is considered inappropriate if it would interfere with the policies or balance of interests embodied in legislation. This was an important consideration in *Zaidan Group Ltd. v. London (City).*[46] The *Zaidan* case was concerned with the right of a municipal ratepayer to claim interest on an overpayment of its taxes. This overpayment had been refunded by the City of London without interest, as allowed under Ontario's *Assessment Act*. Although another provincial enactment conferred power on municipalities to pass by-laws authorizing the payment of interest on overpaid taxes, no by-law on the subject had been passed by the City of London. In these circumstances the ratepayer sought to rely on the common law doctrine of unjust enrichment. It argued that the municipality's use of money to which it was not entitled represented an enrichment for which there was no legal justification. This strategy did not succeed. As Carthy J.A. explained:

> There is no question of a gap being left in the legislation for the common law to fill. The taxes are a statutory creation and the conditions surrounding their payment and repayment must be in the statutes associated with their creation. The common law cannot characterize competent legislation as unjust, and it would be doing so if it imposed an additional duty to pay interest on a statutory duty to levy and to refund a specific amount of money.[47]

Giving each municipality discretion to decide whether interest should be paid in these circumstances was a definitive solution, expressing a policy adopted by

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45 *Ibid.*, at paras. 9-12. The court also pointed out that even if the respondents were able to rely on the common law doctrine of unjust enrichment, they would fail because the Act provided a juristic reason for the enrichment: see para. 17ff.

46 [1990] O.J. No. 33, 71 O.R. (2d) 65 (Ont. C.A.); affd [1991] S.C.J. No. 92, [1991] 3 S.C.R. 593 (S.C.C.).

47 *Ibid.*, at para. 11.

the legislature. To permit recourse to the common law to force the recovery of interest would undermine this policy; it would effectively take back the discretion which the legislature had chosen to confer on the municipality. Given the paramountcy of legislation, this could not be allowed.

***Legislation duplicates or supersedes the common law.*** Resort to the common law is considered inappropriate when in the opinion of the court it is pointless and unnecessary. This was an important consideration in the *Gendron*[48] case. In *Gendron*, the Supreme Court of Canada concluded that resort to the common law would add nothing to the content or effect of the statute and would serve no purpose in the circumstances. This duplication of effort was a valid reason for ousting the common law. L'Heureux-Dubé J. explained:

> ... the common law duty of fair representation is neither "necessary or appropriate" in circumstances where the statutory duty applies. Parliament has codified the common law duty and provided a new and superior method of remedying a breach. It is therefore reasonable to conclude that while the legislation does not *expressly* oust the common law duty of fair representation, it does however effect this end by necessary implication...[49]

Conversely, where legislation adds to the common law without displacing it, so that continued reliance on it serves some useful purpose, the courts are less likely to infer an intention to exclude. In *Rawluk v. Rawluk*,[50] for example, a majority of the Supreme Court of Canada concluded that even though Ontario's *Family Law Act* provided a detailed and comprehensive scheme for the equalization of property upon marriage breakdown, it did not supplant the common law constructive trust. This conclusion was based in part on the Court's finding that the equalization scheme under the Act did not duplicate the work of the constructive trust. As Cory J. explained:

> The constructive trust is used in the matrimonial property context to allocate proprietary interests, a function that is totally distinct from the process of determining how the value of matrimonial property should be distributed under the equalization process.[51]

Cory J. also emphasized the advantages of the common law remedy, which gave the plaintiff a share in the ownership of property as opposed to a personal entitlement to half its value. An intention to eliminate common law advantages is not lightly inferred.

***Common law is unsatisfactory.*** In the *Rawluk* case the common law relied on to supplement the *Family Law Act* was well developed and sophisticated. However, resort to common law rules or remedies that are confused, rudimentary or otherwise unsatisfactory may be inappropriate. In such circumstances the court

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48 *Supra* note 33.
49 *Ibid.*, at para. 45.
50 [1990] S.C.J. No. 4, [1990] 1 S.C.R. 70 (S.C.C.).
51 *Ibid.*, at para. 45.

may infer that the legislation was intended to substitute a coherent legislative regime for the deficient common law.

This thinking is evident in the judgment of Estey J. in *Stubart Investments Ltd. v. R.*[52] In that case the court refused to apply rudimentary common law avoidance rules in the face of a tax avoidance provision that recently had been introduced into the *Income Tax Act*. Estey J. wrote:

> The presence of a provision of general application to control avoidance schemes looms large in the judicial approach to the taxpayer's right to adjust his sails to the winds of taxation... The legislature has provided the standards of unacceptable avoidance procedures, and ... the Court [of Appeal] found itself under no duty, nor indeed possessed of any authority, to legislate new limits. ...[53]

As Estey J. noted, at the time the general anti-avoidance provision was added to the Act, the common law rules in Canada were undeveloped and confused. Before relying on them it would have been necessary for the court to finish devising them. This process of common law evolution was overtaken by the legislation, which anchored further developments in the anti-avoidance area to a statutory basis.[54]

***Legislation offers inadequate solution.*** Despite evidence that legislation is meant to offer an exhaustive regulation of a matter, the court may resort to the common law if it appears that the legislative approach is inadequate. In *Di Pietro v. R.*,[55] for example, the Supreme Court of Canada was concerned with the offence of keeping a common gaming house contrary to s. 185 of the *Criminal Code*. Section 179(1) of the Code contained lengthy and elaborate definitions of the terms "common gaming house" and "game". These appeared to offer a comprehensive and exhaustive account of these elements of the offence. No reference to wagering appeared in either the definition or the offence section itself. Yet the Court concluded that wagering was an essential element of the offence. Lamer J. wrote:

> ... According to the definition of a common gaming house found in s. 179(1), the constituent elements of the offence, are:
>
> 1. keeping a place;
> 2. for gain;
> 3. resorted to by persons for the purpose of playing games;
> 4. which games are games of chance or mixed chance and skill. ...

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52 [1984] S.C.J. No. 25, [1984] 1 S.C.R. 536 (S.C.C.). See also *Seneca College of Applied Arts & Technology v. Bhadauria*, [1981] S.C.J. No. 76, [1981] 2 S.C.R. 181, at 199 (S.C.C.); *Frame v. Smith*, [1987] S.C.J. No. 49, [1987] 2 S.C.R. 99, at 116 (S.C.C.).

53 *Ibid.*, at 6313-14.

54 In fact, the courts that have done little to give effect to the provisions referred to by Estey J. For discussion of recent developments in this area, see Chapter 19, pp. 530ff.

55 [1986] S.C.J. No. 15, [1986] 1 S.C.R. 250 (S.C.C.).

> Although the *Criminal Code* is silent as to the necessity of wagering on the outcome of the game by the players thereof in order to establish that gaming did take place, it has long been recognized by the common law that this is an essential element of gaming.[56]

It is contrary to sound drafting practice to include four of five elements in what purports to be an exhaustive definition. In ordinary circumstances a court would have relied on implied exclusion to conclude that wagering was not a required element of the offence. However, this consideration was outweighed by the need to limit the scope of the section in an appropriate and acceptable way. If wagering were not made a constituent element of the offence, the section would have extended to premises and activities that the legislature could not have intended to criminalize.

***Specific provision displaces general common law.*** When a specific provision applies to the same facts as a general common law rule or remedy and application of the specific provision would be pointless if the common law continued to apply, resort to the common law may be excluded. To avoid rendering the legislative provision tautologous, the court may infer that the common law rule or remedy was meant to be excluded.

This reasoning is illustrated in *Reference re Bill C-62, an Act to Amend the Excise Tax Act (Canada).*[57] In this case the Government of Alberta argued that vendors of supplies who incurred expenses in collecting and remitting tax under the *Excise Tax Act* should be able to rely on the general law of restitution to recover those expenses from the federal Crown. In rejecting this argument, Lamer C.J. wrote:

> ... the GST Act is not entirely silent on the issue of compensation for costs of compliance. Section 346 of the statute provides a one-time transitional credit for small businesses to assist them in offsetting their initial compliance costs. In my opinion, this is a strong indication that Parliament did direct its attention to the question of compensation for compliance costs by enacting a provision providing partial compensation in certain cases. Even if the Attorney General for Alberta were correct to suggest that a more generous right to compensation exists at common law, in my view Parliament decided to substitute for that right its own view of the socially appropriate level of compensation for compliance costs.[58]

By enacting a specific provision addressing cost recovery, the legislature indicated that it had considered the matter but was not satisfied to leave it to the common law; it wished to deal with matter as set out in the legislation. The specific provision would be superfluous if the general law applied.

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56 *Ibid.*, at paras. 15-16.

57 [1992] S.C.J. No. 62, [1992] 2 S.C.R. 445 (S.C.C.). See also *Veilleux v. Quebec (Commission de protection du territoire agricole)*, [1989] S.C.J. No. 34, [1989] 1 S.C.R. 839, at 852 (S.C.C.); folld *Venne v. Quebec (Commission de protection du territoire agricole)*, [1989] S.C.J. No. 32, [1989]1 S.C.R. 880, at 909 (S.C.C.).

58 *Ibid.*, at 477-78.

***Partial codification.*** When the legislature codifies only part of the law relating to a matter, the court may rely on implied exclusion reasoning to conclude that the part of the law not codified was meant to be excluded. In *McClurg v. R.*,[59] for example, one of the issues was whether a corporate director's power to declare dividends under Saskatchewan's *Business Corporations Act* was limited by common law restrictions not mentioned in the Act. In the view of Dickson C.J., the answer was no:

> The power to declare dividends is expressly limited in the Act, in much the same way as it was at common law. For example, s. 40 of the *S.B.C.A.* ... prohibits the declaration of a dividend if there exists reasonable grounds to believe that to do so would leave the corporation unable to pay its debts (s. 40(a)); or, if the payment of a dividend would render the realizable value of the assets of the corporation less than the aggregate of its liabilities and stated capital of all classes of shares (s. 40(b)).... [T]he presence of those limitations in the Act suggests that the power to declare dividends is statutorily limited only by restrictions expressly stated.[60]

Dickson C.J. concluded that additional restrictions might be included in the articles of incorporation but, apart from that, the restrictions set out in the statute were exhaustive. By listing some common law restrictions, the legislature created an expectation that these would be expressly set out in the Act. Restrictions not mentioned were impliedly excluded.

***Mix of considerations.*** In most cases, to determine whether legislation was intended to offer an exclusive regulation of a matter, the court relies on a mix of considerations. This approach is illustrated by the decision of the Nova Scotia Court of Appeal in *Pleau (Litigation Guardian of) v. Canada (Attorney General)*.[61] In that case, after being dismissed from his employment, Mr. Pleau grieved under his collective agreement and was reinstated by the arbitrator. He and his family then brought an action in superior court against the federal government and nine employees for damages for conspiracy to cause injury and for breach of fiduciary duty. The issue was whether the governing labour legislation precluded such an action. Cromwell J.A. wrote:

> The Supreme Court's decisions in St. Anne,[62] Gendron,[63] and Weber[64] show that there are a number of interrelated considerations relevant to whether courts should defer with respect to a particular case to an alternative dispute resolution process established by legislation or agreement of the parties. Absent words clear enough to oust court jurisdiction as a matter of law, the question is whether the

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59 [1990] S.C.J. No. 134, [1990] 3 S.C.R. 1020 (S.C.C.).

60 *Ibid.*, at para. 22.; *cf.* La Forest J., at 248.

61 [1999] N.S.J. No. 448, 182 D.L.R. (4th) 373 (N.S.C.A.).

62 *St. Anne Nackawic Pulp & Paper Co. Ltd. v. Canadian Paperworkers Union, Local 219*, [1986] S.C.J. No. 34, [1986] 1 S.C.R. 704 (S.C.C.).

63 *Gendron v. Supply and Services Union of the Public Service Alliance of Canada, Local 50057*, [1990] S.C.J. No. 55, [1990] 1 S.C.R. 1298 (S.C.C.).

64 *Weber v. Ontario Hydro*, [1995] S.C.J. No. 59, [1995] 2 S.C.R. 929 (S.C.C.).

court should infer, in the particular circumstances, that the alternate process was intended to be the exclusive means of resolving the dispute....

[T]he relevant considerations may be addressed under three headings.

First, consideration must be given to the process for dispute resolution established by the legislation and collective agreement, particularly ... whether the process is expressly or implicitly regarded as an exclusive one. Language consistent with exclusive jurisdiction, the presence or absence of privative clauses and the relationship between the dispute resolution process and the overall legislative scheme should be considered.

Second, the nature of the dispute and its relation to the rights and obligations created by the overall scheme of the legislation and the collective agreement should be considered. In essence, this involves a determination of ... the extent to which the court's assumption of jurisdiction would be consistent or inconsistent with that scheme.

Third, the capacity of the scheme to afford effective redress must be considered. Simply put, the concern is that where there is a right, there ought to be a remedy.[65]

In the *Pleau* case, the court concluded that Parliament did not intend to make grievance arbitration the exclusive recourse available to employees under the *Public Service Staff Relations Act*. It therefore refused to strike out the plaintiffs' cause of action.

## COMMON LAW EVOLUTION PRECLUDED BY LEGISLATION

***Evolution of common law.*** It is well established that common law courts have a jurisdiction to change the common law in response to changing social conditions. In *R. v. Salituro*, Iacobucci J. wrote:

> The courts are the custodians of the common law, and it is their duty to see that the common law reflects the emerging needs and values of our society.[66]

The scope of this jurisdiction is explored by McLachlin J. in *Watkins v. Olafson*:

> Generally speaking, the judiciary is bound to apply the rules of law found in the legislation and in the precedents. ... While it may be that some judges are more activist than others, the courts have generally declined to introduce major and far-reaching changes in the rules hitherto accepted as governing the situation before them. There are sound reasons supporting this judicial reluctance to dramatically recast established rules of law. The court may not be in the best position to assess the deficiencies of the existing law, much less problems which may be associated with the changes it might make. The court has before it a single case; major changes in the law should be predicated on a wider view of how the rule

65 *Supra* note 61, at paras. 48-52.
66 [1991] S.C.J. No. 97, [1991] 3 S.C.R. 654 at para. 54 (S.C.C.).

# TAB 8

*Indexed as:*

# National Bank of Canada v. Merit Energy Ltd.

**IN THE MATTER OF the bankruptcy of Merit Energy Ltd.**
**Between**
**National Bank of Canada, Bank One, NA and Bank One, Canada, plaintiffs, and**
**Merit Energy Ltd., defendant**

[2001] A.J. No. 918

**2001 ABQB 583**

[2001] 10 W.W.R. 305

95 Alta. L.R. (3d) 166

294 A.R. 15

28 C.B.R. (4th) 228

107 A.C.W.S. (3d) 182

Action No. 0001-04994

Bankruptcy No. 073154

Alberta Court of Queen's Bench
Judicial District of Calgary

**LoVecchio J.**

Heard: April 30, 2001.
Judgment: filed July 3, 2001.

(83 paras.)

**Counsel:**

Frank Dearlove and Chris Simard, for Arthur Andersen Inc.

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

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[Quicklaw note: Errata were released from the Court July 5 and 9, 2001. The corrections have been made to the text and the Errata are appended to this document.]

REASONS FOR JUDGMENT

LoVECCHIO J.:--

INTRODUCTION

1 On August 31, 2000, applications were brought by Dundee Securities Corporation, Peters & Co. Limited, Nesbitt Burns Inc., Newcrest Capital Inc., RBC Dominion Securities, Bunting Warburg Dillon Read Inc., First Energy Capital Corporation (being the underwriters in the flow-through common share offering of Merit Energy Ltd., described below), certain directors and officers of Merit Energy Ltd. and Larry Delf, a representative purchaser of flow-through common shares in Merit, to determine whether these applicants were entitled to a priority in the nature of an equitable lien over the proceeds of the sale of Merit's assets.

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

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

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

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

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

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

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

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

BACKGROUND

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

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

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

the omission of which makes or is alleged to make any such information or statement untrue or misleading in light of all the circumstances in which it was made;

(b) any misrepresentation or alleged misrepresentation (except a misrepresentation or alleged misrepresentation which is based upon information relating solely to one or more of the Underwriters and furnished to the Corporation by the Underwriters for inclusion in the Public Record) in the Public Record.

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

[Merit] agrees:

(a) prior to the filing of the Preliminary Prospectus and thereafter and prior to the filing of the Prospectus, to allow the Underwriters to participate fully in the preparation of the Preliminary Prospectus (excluding the documents incorporated therein by reference) and such other documents as may be required under the Applicable Securities Laws in the Filing Jurisdictions to qualify the distribution of the Common Shares in the Filing Jurisdictions and allow the Underwriters to conduct all due diligence which the Underwriters may reasonably require (including with respect to the documents incorporated therein by reference) in order to (i) confirm the Public Record is accurate and current in all material respects; (ii) fulfill the Underwriters' obligations as agents and underwriters; and (iii) enable the Underwriters to responsibly execute the certificate in the Preliminary Prospectus or the Prospectus required to be executed by the Underwriters;

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

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

...

(e) that, during the period commencing with the date hereof and ending on the conclusion of the distribution of the Common Shares, the Preliminary Prospectus and the Prospectus will fully comply with the requirements of Applicable Securities Laws of the Filing Jurisdictions and, together with

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

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

**14** The Prospectus indicated that:

> The gross proceeds of this Offering will be used to incur CEE in connection with the Corporation's ongoing oil and natural gas exploration activities. The Underwriters' fee and the expenses of this Offering will be paid from Merit's general funds...
>
> The Flow-through Common Shares will be issued as Flow-through Shares' under the Act. The Corporation will incur on or before December 31, 2000, and renounce to each purchaser of Flow-through Common Shares, effective on or before December 31, 1999, CEE in an amount equal to the aggregate purchase price equal to the aggregate purchase price paid by such purchaser.
>
> Subscriptions for Flow-through Common Shares will be made pursuant to one or more subscription agreements ('Subscription Agreements') to made between the Corporation and one or more of the Underwriters or one or more sub-agents of the Underwriters, as agent for, on behalf of and in the name of the purchasers of Flow-through Common Shares...

**15** The Prospectus also indicated that:

> ... Pursuant to the Subscription Agreements, the Corporation will covenant and agree (i) to incur on or before December 31, 2000 and renounce to the purchaser,

> effective on or before December 31, 1999, CEE in an amount equal to the aggregate purchase price paid by such purchaser for the Flow-Through Common Shares and (ii) that if the Corporation does not renounce to such purchaser, effective on or before December 31, 1999, CEE equal to such amount, or if there is a reduction in such amount renounced pursuant to the provision of the Act and as the sole recourse of the purchaser for such failure or reduction, the Corporation shall indemnify the purchaser as to, and pay in settlement thereof to the purchaser, an amount equal to the amount of any tax payable or that may become payable under the Act...by the purchaser as a consequence of such failure or reduction...
>
> In respect of CEE renounced effective on December 31, 1999, and not incurred prior to the end of the period commencing on the date that the Subscription Agreement is entered into and ending on February 29, 2000, the Corporation will be required to pay an amount equivalent to interest to the Government of Canada. Any amount of CEE renounced on December 31, 1999 and not incurred by December 31, 2000 will result in a reassessment of deductible CEE to subscribers. However, interest in respect of additional tax payable under the Act by a purchaser of Flow-Through Common Shares will generally not be levied in respect of such reassessment until after April 30, 2001.

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

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

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

> To the full extent allowed by law, [Merit]...agrees to indemnify and save harmless the Indemnified Party, his heirs, successors and legal representatives from and against any and all damages, liabilities, costs, charges or expenses suffered or incurred by the Indemnified Party, his heirs, successors or legal representatives as a result of or by reason of the Indemnified Party being or having been a director and/or officer of [Merit] or by reason of any action taken by the Indemnified Party in his capacity as a director and/or officer of [Merit],

> including without limitation, any liability for unpaid employee wages, provided that such damages, liabilities, costs, charges or expenses were not suffered or incurred as a direct result of the Indemnified Party's own fraud, dishonesty or wilful default.

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

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

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

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

ISSUES

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

DECISION - ISSUE 1

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

ANALYSIS

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

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

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

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

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

> return of capital in the direct sense. What is being claimed, however, is an award of damages measured as the difference between the "true" value of Blue Range shares and their "misrepresented" value - in other words, money back from what Big Bear "paid" by way of consideration...A tort award to Big Bear could only represent a return of what Big Bear invested in equity of Blue Range. It is that kind of return that is limited by the basic common law principle that shareholders rank after creditors in respect of any return on their equity investment. ...
>
> I find that the alleged share exchange loss derives from and is inextricably intertwined with Big Bear's shareholder interest in Blue Range. The nature of the claim is in substance a claim by a shareholder for a return of what it invested qua shareholder, rather than an ordinary tort claim.

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

(i) the claims of shareholders rank behind the claims of creditors in insolvency;
(ii) creditors do business on the assumption that they will rank ahead of shareholders in the event of their debtor's insolvency;
(iii) shareholders are not entitled to rescind their shares on the basis of misrepresentation after the company has become insolvent;
(iv) United States jurisprudence supports the priority of creditors in "stockholder fraud" cases; and
(v) to allow the shareholders to rank pari passu with the unsecured creditors could open the floodgates to aggrieved shareholders launching misrepresentation actions.

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

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

> As I see it, the fact that the transaction contains both debt and equity features does not, in itself, pose an insurmountable obstacle to characterizing the advance of $255 million. Instead of trying to pigeon-hole the entire agreement between

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

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

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

i. The Trustee's Position

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

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

ii. The Flow-Through Shareholders' Position

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

The Representative Flow-Through Shareholders Group's Position

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

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

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

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

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

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

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

The Other Flow-Through Shareholders Group's Position

40 Mr. Shea suggested that not only were the claims for tax losses relating to the CEE provable claims, the tort/statutory aspects of their claims were also provable claims, albeit they would be dealt with as "contingent" claims within the meaning of ss. 121 and 135 of the BIA[9]. He further submitted that the fact they are claims by shareholders is irrelevant.

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

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

43 Mr. Shea then argued that it would not be equitable to subordinate these claims while other

claims based on tort, breach of contract or statutory remedy are allowed to rank as unsecured claims and concluded that the traditional principles for subordinating claims by shareholders do not apply to this case.

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

iii. The Underwriters' Position

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

**46** The Underwriters also suggested that Re: Blue Range Resource Corp turned on its unique facts of a purchaser of Blue Range shares having knowledge of misrepresentations yet exercising shareholder rights, such as authorizing the company to take CCAA proceedings and then making an unsecured claim in those proceedings for the loss associated with its share purchase. The shareholder in that case did not claim recision and did not deny or attempt to avoid its shareholder status. Moreover, there was no contractual right to be treated by the company as anything but a shareholder.

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

Resolution- ISSUE 1

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

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

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

**51** Now what about the second aspect of the claims?

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

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

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

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

DECISION - ISSUE 2

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

i. The Trustee's Position

**56** The Trustee argued that while on their face, the Underwriters' and the Directors and Officers' claims are not shareholder claims, "in substance", they are shareholders' claims and are no more than an indirect passing-on to Merit of the Flow-Through Shareholders' claims. As a result, the Trustee submitted, equity dictates that since the Flow-Through Shareholders' claims must rank behind those of the unsecured creditors, the claims of the Underwriters and the Directors and Officers must fail as well. The Trustee suggested this subordination follows from the policy considerations set out by Romaine J. in Re: Blue Range Resource Corp. Alternatively, the Trustee asserted that the claims of the Underwriters and the Directors and Officers are so contingent they must be valued at nil.

ii. The Underwriters' Position

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

iii. The Directors' and Officers' Position

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

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

claims, but rather they are making a contractual claim for all the potential liability they face, as the indemnity intends.

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

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

Resolution - ISSUE 2

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

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

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

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

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

right against Merit.

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

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

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

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

2. Creditors do business with companies on the assumption they will rank ahead of shareholders on insolvency - the focus of this analysis is the degree of risk-taking respectively assumed by shareholders and creditors. Unlike shareholders who assume the risks of insolvency, the Underwriters bargained, as any other creditor,

for their place at the creditor table in an insolvency. An indemnity is a well-known commercial concept business people routinely use to eliminate or reduce risk and should be recognized as a necessary and desirable obligation.

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

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

3. Shareholders are not entitled to rescind shares after insolvency - this consideration has no bearing on the Underwriters as they are not shareholders seeking to rescind shares. Their claims against the bankrupt are for damages under a contract for indemnity. Further, I was not asked to determine this particular question in this application.
4. The principles of equitable subordination - In Re Canada Deposit Insurance v. Canadian Commercial Bank, the Supreme Court of Canada expressly left open the question of whether equitable subordination formed part of Canadian insolvency law, but expressed its opinion as to the applicable test as developed in the United States:

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

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

Although the Trustee suggested that the Underwriters may have "participated" in the misrepresentation, there is no evidence before me of inequitable conduct on

their part. It is perhaps significant that the Flow-Through Shareholders have not alleged any such misconduct as against the Underwriters, but rather they have only advanced the statutory causes of action available to them under securities legislation.

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

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

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

This statement encapsulates what the Trustee is asking to the Court to do: subordinate the claims of the Underwriters, who have asserted their claims under their indemnities as they are entitled to do, merely because the result may be perceived as inequitable. The words of the US Supreme Court are consistent with the view that equitable subordination is an extraordinary remedy that ought to be employed only where there is some misconduct on the part of the claimant. The statutory scheme of distribution in the BIA must be paramount, and if it is to be interfered with, it should only be in clear cases where demonstrable inequitable conduct is present.

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

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

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

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

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

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

Contingent claims

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

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

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

Underwriters and/or the Directors and Officers to the Flow-Through Shareholders would qualify for indemnification.

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

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

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

iv. PriceWaterhouseCoopers

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

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

81 I am aware that the indemnities of the Flow-Through Shareholders are not being accorded creditor status, while those of the Underwriters, the Directors and Officers and PriceWaterhouseCoopers are. However, as noted, the indemnity feature of the Flow-Through

Shareholders' claims is related to certain deductions and those deductions were part of the purchase price for the shares. This in my view is more analogous to Re Canada Deposit Insurance v. Canadian Commercial Bank than to Re Central Capital Corporation and that to me is sufficient to justify the distinction.

CONCLUSION

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

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

LoVECCHIO J.

* * * * *

ERRATUM

Released: July 5, 2001

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

ERRATUM

Released: July 9, 2001

Please replace page 2 of your copy of the Judgement.

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

cp/i/qlrds/qlcas/qlhjk

1 Reasons followed the dismissal from the bench, [2001] A.J. No. 760, 2001 ABCA 138.

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

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

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

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

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

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

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

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

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

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

11 (1997), 43 C.B.R. (3d) 4.

12 (1993), 22 C.B.R. (3d) 56 (Sask.Q.B.), referred to favourably by Farley J. in Canadian Triton International Ltd. (Re) (1997), 49 C.B.R. (3d) 192 (Ont. Gen. Div.) and followed in Re Wiebe (1995), 30 C.B.R. (3d) 109 (Ont. Gen. Div.)

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

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

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

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

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

18 ibid.

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

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

# TAB 9

*Case Name:*

# Earthfirst Canada Inc. (Re)

**IN THE MATTER OF the Companies' Creditors Arrangement Act R.S.C. 1985, c. C-36, as Amended AND IN THE MATTER OF a Plan of Compromise or Arrangement of Earthfirst Canada Inc.**

[2009] A.J. No. 749

**2009 ABQB 316**

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

2009 CarswellAlta 1069

Docket: 0801 13559

Registry: Calgary

Alberta Court of Queen's Bench
Judicial District of Calgary

**B.E.C. Romaine J.**

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

(5 paras.)

**Counsel:**

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

Howard A. Gorman, for Earthfirst Canada Inc.

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

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

## Reasons for Judgment

B.E.C. ROMAINE J.:--

## INTRODUCTION

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

## FACTS

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

> 6.(b) to incur, during the Expenditure Period, Qualifying Expenditures in such amount as enables the Corporation to renounce to each Subscriber, Qualifying Expenditures in an amount equal to the Commitment Amount of such Subscriber;
>
> (c) to renounce to each Subscriber, pursuant to subsection 66(12.6) and 66(12.66) of the Tax Act and this Subscription Agreement, effective on or before December 31, 2007, Qualifying Expenditures incurred during the Expenditure Period in an amount equal to the Commitment Amount of such Subscriber;
>
> ...
>
> (g) if the Corporation does not renounce to the Subscriber, Qualifying Expenditures equal to the Commitment Amount of such Subscriber effective on or before December 31, 2007 and as the sole recourse to the Subscriber for such failure, the Corporation shall indemnify the Subscriber as to, and pay to the Subscriber, an amount equal to the amount of any tax payable under the Tax Act (and under

any corresponding provincial legislation) by the Subscriber (or if the Subscriber is a partnership, by the partners thereof) as a consequence of such failure, such payment to be made on a timely basis once the amount is definitively determined, provided that for certainty the limitation of the Corporation's obligation to indemnify the Subscriber pursuant to this Section shall not apply to limit the Corporation's liability in the event of a breach by the Corporation of any other covenant, representation or warranty pursuant to this Agreement or the Underwriting Agreement;

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

**ISSUE**

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

**ANALYSIS**

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

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

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

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

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

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

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

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

The Court of Appeal in dismissing the appeal commented:

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

The decision in Merit Energy thus determines the issue in this case, which is not distinguishable on

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

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

**CONCLUSION**

I therefore grant:

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

B.E.C. ROMAINE J.

* * * * *

**Corrigendum**

Released: July 8, 2009

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

cp/e/qlcct/qlpwb/qlltl/qlaxr

# TAB 10

*Case Name:*

**JED Oil 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 the Business Corporations Act, R.S.A. 2000 C. B-9 AND IN THE MATTER OF a Plan of Compromise or Arrangement of JED Oil Inc. and its Subsidiaries JED Production Inc. and JED Oil (USA) Inc.**

[2010] A.J. No. 512

2010 ABQB 295

68 C.B.R. (5th) 115

2010 CarswellAlta 861

Docket: 0801 09492

Registry: Calgary

Alberta Court of Queen's Bench
Judicial District of Calgary

**C.A. Kent J.**

Heard: April 21, 2010.
Judgment: May 3, 2010.

(17 paras.)

*Bankruptcy and insolvency law -- Creditors -- Unsecured creditors -- Application by creditors of the bankrupt, formerly granted relief under the Companies' Creditors Arrangement Act, for a declaration that their dividend claims were a return on equity such that they were excluded from the unsecured creditors class both with respect to voting and participation under the plan, granted -- The only way the court could find the dividends were declared before the agreed date of insolvency was if the wording of shares meant that the dividends were declared as of the date of issuance of the shares -- This would require more explicit wording than was contained in these shares.*

*Bankruptcy and insolvency law -- Companies' Creditors Arrangement Act matters -- Compromises and arrangements -- With unsecured creditors -- Applications -- Application by creditors of the bankrupt, formerly granted relief under the Companies' Creditors Arrangement Act, for a declaration that their dividend claims were a return on equity such that they were excluded from the unsecured creditors class both with respect to voting and participation under the plan, granted -- The only way the court could find the dividends were declared before the agreed date of insolvency was if the wording of shares*

*meant that the dividends were declared as of the date of issuance of the shares -- This would require more explicit wording than was contained in these shares.*

Application by creditors of the bankrupt JED Oil Inc., formerly granted relief under the Companies' Creditors Arrangement Act, for a declaration that their dividend claims were a return on equity such that they were excluded from the unsecured creditors class both with respect to voting and participation under the plan. The applicants were holders of Series B Preferred Shares of JOI, and they argued their dividend claims were not debt and that they ought not to rank equally with the unsecured creditors, as proposed by the monitor and JED. The issue was whether the dividend claims were debt or equity. Both sides agreed that debt ranked ahead of equity and that dividends were equity until they were declared, at which time they became debt. The applicants argued that on the date the shares were issued there was no debt, as dividends had not yet been declared. They argued that dividends could not be declared until the end of each financial quarter, that the corporation could not issue shares that in effect make the shareholders creditors, and that given s. 43 of the Business Corporations Act, any share term purporting to make an advance declaration of dividends would be ultra vires the corporation. Finally, they argued that even if the dividend was declared, if there were no funds to pay it, it was a nullity.

HELD: Application granted. The preferred shareholders were excluded from the unsecured creditors class and they were not entitled to any distribution within that class. The only way the court could find the dividends were declared before Feb. 1, 2008, the agreed date of insolvency of JED, was if the wording of shares meant that the dividends were declared as of the date of issuance of the shares, with the result that the shareholders became creditors of the company from the day that they were issued their shares. The substance of the relationship between the shareholders and the corporation at the time they purchased their shares was not that of creditor and debtor. They were risk-takers, not creditors. For them to become creditors from the time they were issued the shares would require more explicit wording than was contained in these shares.

**Statutes, Regulations and Rules Cited:**

Business Corporations Act, RSA 2000, c. B-9, s. 43

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

**Counsel:**

Trevor A. Batty, Burnet, for certain creditors.

Marcia L. Johnston, Q.C., for the Series B Preferred Shares.

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**Reasons for Judgment**

**1 C.A. KENT J.**:-- On August 13, 2008, I granted an order giving JED Oil Inc. and related companies relief under the *Companies' Creditors Arrangement Act*, R.S.C. 1985 as amended. About 100 holders of Series B Preferred Shares of JOI submitted proofs of claim in respect of dividends that they said were payable from January, 2008 until August 12, 2008.

**2** On September 3, 2009, JED obtained an order to hold a meeting of JED's creditors to consider its Amended and Restated Plan of Arrangement. The Plan provided for four classes of affected creditors. One of those classes was Unsecured Creditors. The Monitor and JED accepted the dividend claims of

the preferred shareholders as being unsecured claims and included them in the Unsecured Creditors class. The Plan was approved and sanctioned by the Court, but subject to this application.

3 The Plan provided that the Unsecured Creditors class would receive Class B Special Shares of the restructured JED in proportion to their claims. The creditors who bring this application argue that the dividend claims are not debt and should not rank equally with the unsecured creditors. They seek a declaration that the dividend claims are a return on equity so that they are excluded from the Unsecured Creditors class both with respect to voting and participation under the Plan.

4 The issue is whether the dividend claims are debt or equity.

5 The relevant terms of the Series B Preferred Shares reads as follows:

> (4) Entitlement to Dividends
>
> (a) Entitlement
>
> Holder of Series B Preferred Shares shall be entitled to receive dividends calculated at the rate of ten percent (10%) per annum of the Redemption Amount per share for the number of Series B Preferred Shares so held, accruing from the date of issuance through the date each such Series B Preferred Share is converted to a Common Share or redeemed by the Corporation.
>
> (b) Quarterly Payments
>
> Dividends shall be paid quarterly, to the holder of record of the Series B Preferred Shares on the last day of each calendar quarter, commencing September 30, 2006. Payments shall be issued on the fifteenth day of the month following the end of each such calendar quarter.

6 Some facts and some legal principles that are not in dispute. Specifically, it is agreed that as of February 1, 2008, JED was insolvent. Both sides agree that debt ranks ahead of equity and that dividends are equity until they are declared at which time they become debt.

7 *Re Central Capital Corp.* (1996), 132 D.L.R. (4th) 223 (Ont. C.A.), is instructive for the issues before me. McCutcheon and SYH were holders of preferred shares with a right to have their shares redeemed on a specific date at a specific value. McCutcheon had acquired his shares through the sale of shares in another company for which he received cash and the redeemable shares. SYH sold its shares in insurance companies for the redeemable shares.

8 The majority of the court found that the relationship between McCutcheon and SYH on one hand and Central Capital on the other was one of equity, not debt, for two reasons. One was the wording of the Articles which contained none of the indicia of debt. Second was the nature of the relationship of the shares to the structure of the corporation. McCutcheon and SYH continued to have the rights attached to their shares. Thus the nature of the relationship - equity, not debt - did not change. Because the dividends had not been declared, the majority also found no debt created.

9 Laskin, J.A., in his reasons, set out the challenge when dealing with the characterization of preferred shares. At para. 117, he says:

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

> Invariably the conditions attaching to preferred shares contain attributes of equity and, at least in an economic sense, attributes of debt. Over the years financiers and corporate lawyers have blurred the distinction between equity and debt by endowing preferred shareholders with rights analogous to the rights of creditors.

And, at para. 119, he says:

> If the certificate or instrument contains features of both equity and debt - in other words if it is hybrid in character - then the Court must determine the "substance" of the relationship between the holder of the certificate and the company. This is the lesson of Justice Iacobucci's judgment in *Canada Deposit Insurance Corp. v. Canadian Commercial Bank,* [1992] 3 S.C.R. 558.

**10** In this case, the Applicants rely heavily on *Central Capital* in making five points. First, they say that on the date that the shares were issued, there was no debt because dividends had not been declared. Only on the last calendar day of each quarter would the company have sufficient information including the identity of the payee to declare the dividends. Secondly, the board would not know the status of the company until the end of each quarter so they could not declare the dividends until then.

**11** Third, the corporation cannot issue shares that in effect make the shareholders creditors. In Grover and Ross, *Materials and Corporate Finance*, cited in *Central Capital* at para. 132:

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

**12** Fourth, given s. 43 of the *Business Corporations Act*, any share term which purports to make an advance declaration of dividends would be *ultra vires* the corporation. S. 43 reads:

> Dividends
>
> 43 A corporation shall not declare or pay a dividend if there are reasonable grounds for believing that

(a) the corporation is, or would after the payment be, unable to pay its liabilities as they become due, or
(b) the realizable value of the corporation's assets would thereby be less than the aggregate of its liabilities and stated capital of all classes.

**13** Finally, they argue that even if the dividend has been declared, if there are no funds to pay it, the declaration is a nullity. In *Corporate Finance and Canadian Law*, (Toronto: *Thomson Canada Ltd.*, 2000), Professor Nicholls says at p. 24:

> While the matter is not entirely free from doubt, it would appear that the better view of the law is that - in jurisdictions which CBCA-type dividend payment restrictions - when dividends have been lawfully declared, but cannot be lawfully paid,

> shareholders do not have an enforceable debt claim against the corporation. The contractual right of shareholders to sue for the payment of declared dividends appears, at common law, not to have arisen until the directors had determined that dividends could lawfully be paid. It may be that it is appropriate for that determination to be made once only, at the time of the declaration, if the governing corporate statute - such as the B.C. *Company Act* - does not expressly mandate that the solvency tests be satisfied, first, before declaration and again before payment. But the CBCA does expressly refer both to declaration and payment.

**14** In response, the preferred shareholders argue s. 43 makes a distinction between declaring and paying a dividend. There is no reason why shares cannot be set up so that dividends are declared in advance but not paid until the payment date when the company knows if it is able to pay. At the date the shares were issued, all the information was available to declare the dividend. Furthermore, at the end of each quarter, shareholders can elect to take cash or shares. At the end of the first quarter of 2008, although the directors did not pay any cash because JED was insolvent, they did pay in shares until such time as it was realized that issuing those many shares would change control of the company. The act of issuing the shares shows that the board had already declared a dividend.

**15** In answer to several of the unsecured creditors' arguments, they argue that *Central Capital* is of little assistance since it was dealing with retraction of shares rather than the declaration of a dividend.

**16** The issue I must decide is whether the dividends were declared before February 1, 2008. The only way that I can so find is if I find that the wording of shares means that the dividends were declared as of the date of issuance of the shares, with the result that the shareholders became creditors of the company from the day that they were issued their shares. The substance of the relationship between the shareholders and the corporation at the time they purchased their shares is not that of creditor and debtor. They are risk-takers, not creditors. For them to become creditors from the time they are issued the shares would require more explicit wording than is contained in these shares.

**17** In the result, the application is granted. The preferred shareholders are excluded from the Unsecured Creditors class and they are not entitled to any distribution within that class.

C.A. KENT J.

cp/e/qlcct/qljxr/qlcas/qlced

# TAB 11

*Case Name:*
**Dexior Financial Inc. (Re)**

**IN THE MATTER OF the Bankruptcy of Dexior Financial Inc.**

[2011] B.C.J. No. 477

2011 BCSC 348

75 C.B.R. (5th) 298

2011 CarswellBC 624

Docket: B080055

Registry: Vancouver

British Columbia Supreme Court
(In Bankruptcy and Insolvency)
Vancouver, British Columbia

**D.M. Masuhara J.**
**(In Chambers)**

Heard: January 31, 2011.
Judgment: March 22, 2011.

(21 paras.)

*Bankruptcy and insolvency law -- Creditors and claims -- Claims -- Equitable claims -- Disallowance of -- Trustee authorized to disallow claims in bankruptcy of Dexior -- Investors with shares whose funds had been invested in ill-conceived projects and who had never received dividends were nonetheless shareholders, not creditors -- Investors in other entities needed to claim against those entities -- Investors who claimed they had been defrauded also had claims disallowed, as fraud claims too closely connected with equity claims -- Bankruptcy and Insolvency Act, ss. 2, 34.*

Application by the trustee of Dexior for direction with respect to the validity of some claims. The trustee received 67 claims totalling $18,823,688. Of those, 30 equity claims totalled $9,375,000. These claimants included investors who had purchased and had been issued Dexior shares, investors who claims for dividends, investors who gave notices of redemption to Dexior prior to its bankruptcy, investors who made advances to an entity other than Dexior, investors who made advances through Dexior to another entity, and investors who bought shares but claimed to have been defrauded by Dexior. Dexior's proposal was voted down and it became bankrupt on February 2008. While in business, Dexior's funds were invested in ill conceived projects. It was never in a position to pay dividends to its investors, and no dividends had ever been declared. Responding to the trustee's application was Halltray, the holder of preferred shares of Dexior. Halltray took the position its claim as an equity creditor was

valid given that it had provided a notice of retraction prior to the bankruptcy.

HELD: The trustee was authorized to disallow those equity claims he identified. The first three categories of investors were shareholders, not creditors, of Dexior. Their investments formed part of Dexior's capital. Their position was not equivalent to that of ordinary creditors. Claims of investors who made advances to other entities should have been advanced against those other entities. The claims of investors who had allegedly been defrauded were too closely connected with the underlying equity claims.

**Statutes, Regulations and Rules Cited:**

Bankruptcy Act,

Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3, s. 2, s. 34

**Counsel:**

Counsel for Trustee in Bankruptcy: J.I. MacLean, Q.C.

Counsel for Halltray Farms Ltd.: G. Dabbs.

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**Reasons for Judgment**

D.M. MASUHARA J.:--

**Introduction**

**1** Pursuant to s. 34 of the *Bankruptcy and Insolvency Act*, R.S. 1985, c. B-3 [BIA], the Trustee in Bankruptcy of Dexior Financial Inc. ("Dexior") seeks directions with respect to the validity of a number of claims received.

**2** The Trustee has received approximately 67 claims to date totalling $18,823,688. Of those claims, the Trustee says some 30 involve equity claims and the equity component totals approximately $9,375,000.

**3** The Trustee puts the equity claims into the following categories:

(a) Investors who purchased shares in Dexior and have had shares issued to them.
(b) Investors who have claimed for dividends on their shares in Dexior, in accordance with statements issued to them showing such dividends.
(c) Investors who gave a notice of redemption to Dexior but the notice period had not run out before the date of bankruptcy.
(d) Investors who made advances to an entity other than Dexior.
(e) Investors who made advances through Dexior Financial Inc. to an entity other then Dexior.
(f) Investors who bought shares but claim to have been defrauded by Dexior.

**4** Dexior filed a Notice of Intention to Make a Proposal on December 17, 2007. A Proposal was subsequently filed but voted down at the meeting of auditors on February 12, 2008. As a result, Dexior

became bankrupt on February 12, 2008.

**5** The Trustee deposes that:

(a) Dexior was under the de facto control of Mr. Gerard Darmon and Mr. Mohammed Jiwani;
(b) funds raised by Dexior were invested in a series of projects or investments that were ill conceived;
(c) Dexior was never in a position to pay dividends or fund the retraction of Class J to M shares from "profits" as none of the projects ever produced any profits for Dexior; and
(d) a review of the corporate records of Dexior does not disclose any dividends of any shares having been declared by the directors.

**6** The Trustee is of the view that the above-mentioned claims should be disallowed as they are equity claims and seeks the courts direction in this regard.

**Discussion**

**7** The only respondent appearing at this hearing was Halltray Farms Ltd. ("Halltray"). Halltray was a holder of Class P preferred shares in Dexior. Its claim in regard to this hearing relates to its investment of $1 million in the preferred shares. It concedes that it was a shareholder and thus had an equity claim but submits that its status changed to that of an ordinary creditor when it provided its notice of intention seeking retraction of its shares and as such is eligible to participate in a distribution. The notice was provided May 10, 2007. Halltray says that although the end of the notice period applicable to its retraction notice had not run out prior to the date of Dexior filing its Notice of Intention pursuant to the *BIA* the end of its retraction notice period had run out prior to the date of the bankruptcy on February 12, 2008. The Trustee during the course of the hearing advised that Halltray was the only claimant to have delivered a retraction notice.

**8** Halltray relies primarily upon Re *East Chilliwack Agricultural Co-operative,* 58 D.L.R. (4th) 11 (B.C.C.A.) in support of its position. The facts in *East Chilliwack* are similar to those as in this case. The case involved members of the cooperative who had given written notice of their intention to withdraw. The rules of the cooperative provided that the withdrawing member would cease to be a member at the time of the notice and could elect to have his share redeemed either in equal instalments over five years or in one payment with interest at the end of five years. The cooperative subsequently made a voluntary assignment in bankruptcy. The Trustee sought directions from the court as to whether the withdrawing members could file as unsecured creditors under the then *Bankruptcy Act.*

**9** The majority in *East Chilliwack* decided that the withdrawing member having provided his notice was an unsecured creditor and not a shareholder. They focused on the fact that the withdrawing member had ceased to be a member by operation of the co-operative's memorandum of association and as such was "no longer to participate in the profits of the co-operative enterprise as a shareholder".

**10** The cases relied upon by the Trustee in respect to all of the claims identified in this proceeding are: *Re Blue Range Resource Corp.*, 2000 ABQB 4, 15 C.B.R. (4th) 169 [*Blue Range*]; *Canada Deposit Insurance Corp. v. Canadian Commercial Bank*, [1992] 3 S.C.R. 558 [*CDIC*]; *Re Central Capital Corp.* (1996), 132 D.L.R. (4th) 223 (Ont. C.A.); *National Bank of Canada v. Merit Energy Ltd.*, 2001 ABQB 583, 28 C.B.R. (4th) 228 [*Merit Energy*]; and *National Bank of Canada v. Merit Energy Ltd.*, 2002 ABCA 5, [2002] 3 W.W.R. 215.

**11** A review of the cases referred to by the Trustee indicates that the jurisprudence as it is today

appears to have overtaken the majority view in *East Chilliwack*. The leading case being the Supreme Court of Canada in *CDIC*. In that case, Iaccobucci J. identified that the characterization of the transaction under review requires the determination of the intentions of the parties. In other words, to determine what the substance of the arrangement reflects. He stated at 37:

> As I see it, the fact that the transaction contains both debt and equity features does not, in itself, pose an insurmountable obstacle to characterizing the advance of $255 million. Instead of trying to pigeonhole the entire agreement between the Participants and CCB in one of two categories, I see nothing wrong in recognizing the arrangement for what it is, namely, one of a hybrid nature, combining elements of both debt and equity but which, in substance, reflects a debtor-creditor relationship. Financial and capital markets have been most creative in the variety of investments and securities that have been fashioned to meet the needs and interests of those who participate in those markets. It is not because an agreement has certain equity features that a court must either ignore these features as if they did not exist or characterize the transaction on the whole as an investment. There is an alternative. It is permissible, and often required, or desirable, for debt and equity to co-exist in a given financial transaction without altering the substance of the agreement. Furthermore, it does not follow that each and every aspect of such an agreement must be given the exact same weight when addressing a characterization issue. Again, it is not because there are equity features that it is necessarily an investment in capital. This is particularly true when, as here, the equity features are nothing more than supplementary to and not definitive of the essence of the transaction. When a court is searching for the substance of a particular transaction, it should not too easily be distracted by aspects which are, in reality, only incidental or [page591] secondary in nature to the main thrust of the agreement.
>
> The weight to be given to one aspect of the support agreements over another in assessing the true intention of the parties underlies the difference in opinion between the learned chambers judge and the Court of Appeal's characterization of the transaction. Wachowich J. emphasized both the fact that the recovery by the Participants of their contribution was dependent upon the income generated by CCB and the Participants' potential to share in the future success of CCB by the warrants, even after having been repaid, as evidencing that the essence of the transaction was that of a capital investment. The Court of Appeal, however, largely dismissed the relevance of the Equity Agreement because of its contingent nature and emphasized instead that the Participants were only entitled to receive from CCB the amount advanced to it and that the parties had included specific provisions in the Participation Agreement referring to debt; all of which amounted to a very strong indicium of a loan.

[Emphasis Added]

**12** The dissenting opinion of Justice Craig in *East Chilliwack* appears to be in line with the views in the above quoted passage from *CDIC*. At 19, he stated:

> When a person subscribes for shares in a co-operative, he contributes his capital in varying amounts hoping that he will eventually participate in the profits by way of dividends or bonuses. I agree with the submission of counsel for the respondents that the court must look at the contributions at the time when they are made in order to ascertain their nature, that is, whether they are to be contributions to the business or

> whether they are to be by way of loan. Here, the appellants contributed to the capital of the business which was carried on for the joint benefit of an members of the association with a view to participating in the profits by way of dividends or bonuses. It would be grossly inequitable to allow these withdrawing members to compete with trade creditors in the case of a bankruptcy. I think the extract from Halsbury cited by Ritchie, J. in Sukloff, [1964] S.C.R. 459, is apposite in this case. [Emphasis added]

**13** The majority decision did not focus on the nature of the relationship when the shares were purchased or the substance relationship underlying the claim. The majority in *East Chilliwack* focussed on the fact that the withdrawing shareholder in the cooperative had ceased to be a member upon delivering his notice of intention to withdraw as a member. I also note that counsel for the Trustee in the instant case advises that the articles applicable to the terms of the shares held by Halltray are standard terms applicable to preferred shares and further do not say that Halltray ceases to be a shareholder upon provision of a retraction notice. Counsel for Halltray did not contest this point. Further, counsel for Halltray did not provide submissions with respect to any other aspect of the articles of Dexior applicable to the subject preferred shares which could distinguish the claim from *CDIC* or *Re Central Capital Corp.*

**14** I note as well that the preferred shares are identified as forming part of the capital of Dexior. In Part 44 of the articles of Dexior specify that the preferred shareholders rank with other shareholders in a defined priority in the event of liquidation, dissolution or winding up of the company or other distribution of its assets among the members for the purpose of winding up its affairs, distribution of property and assets of the company. There is no suggestion that these shareholders have priority equivalent to ordinary creditors.

**15** Counsel for the Trustee also notes that *Re Central Capital Corp.* also dealt with the retraction rights in preferred shares and that the Ontario Court of Appeal in a 2-1 decision declined to follow *East Chilliwack.* I note particularly the comments of Laskin J.A. at 269 and 270 where he set out several reasons for not accepting *East Chilliwack* as follows:

> ... I decline to apply *East Chilliwack* for three reasons. First, because the case was decided in 1989, the British Columbia Court of Appeal did not have the benefit of the Supreme Court of Canada's reasons in *CDIC v. CCB, supra.* In *East Chilliwack* Hutcheon J.A., writing for the majority, did not focus on what the parties intended when the member contracted with the co- operative. Instead he only considered the relationship between the member and the co-operative after the member had withdrawn. I do not think his approach is consistent with Justice Iacobucci's judgment in *CDIC v. CCB, supra.*
>
> Second, there are important factual differences between *East Chilliwack* and the appeals before us. Justice Weiler has referred to these factual differences in her reasons. The most important of these differences are the following: in *East Chilliwack* the rules of the association provided that a member had to withdraw from the association to trigger the right of redemption, whereas the appellants' share conditions provide that they continue to be shareholders of Central Capital until their shares are redeemed; in *East Chilliwack* the member elected to withdraw and redeem his shares when the association was solvent whereas when the appellant McCutcheon exercised his right of retraction Central Capital was insolvent; and in *East Chilliwack* Hutcheon J.A. expressly stated that he was not considering the effect of the superintendent's power to suspend payments if the financial position of the co-operative was impaired, whereas the effect of the statutory prohibition against Central Capital making

> payment, found in s. 36(2) of the *Canada Business Corporations Act*, is in issue in these appeals.
>
> Third, the decision in *East Chilliwack* is at odds with most of the American case-law and I favour the American approach. When a company repurchases shares by instalment and bankruptcy intervenes, the prevailing American position is that the shareholder's claim is deferred to the claims of ordinary creditors. The decision of the Fifth Circuit Court of Appeals in *Robinson v. Wangemann*, 75 F. 2d 756 (1935), is frequently cited. The facts of that case are virtually identical to the facts in *East Chilliwack.*

In my view the authorities subsequent to *East Chilliwack* lead me to conclude that in this case the claims of the respondents as described by the Trustee in paras. 3(a), (b) and (c), which include Halltray's, in respect to the preferred shares, are equity claims. As earlier noted respondent's counsel conceded that Halltray held equity claims until their notice of retraction.

**16** Counsel for Halltray points out that the circumstances of Halltray are different from those in *CDIC* and *Central Capital* in that Halltray had provided its retraction notice prior to bankruptcy whereas in the other two cases the claims arose after bankruptcy. In my view, that distinction does not assist Halltray as the notice does not change the original intention or substance of the claim. I note that there have been some recent cases in other provinces which indicate that a judgment obtained with respect to claims such as in this case could entitle the judgment holder to have a claim equal to other claimants, see for example: *I. Waxman & Sons Limited (Re)*, (2008) 89 O.R. (3d) 427 (S.C.). However in this case no such judgment had been obtained.

**17** I further note that the recent statutory changes to the *BIA*, which are not applicable to this case as they did not take effect until after this bankruptcy, would deem the claims identified in this case as equity claims. The amendments reflect the trend in case authority in the characterization of equity claims. Section 2 of the *BIA* now defines such claims 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).

**18** Given all of the foregoing, I conclude that the claims as set out in paragraphs 3(a), (b), and (c) above should be disallowed.

**19** The claims as set out in paragraphs 3(d) and (e) should be disallowed on the basis that the claims are in relation to investments for preferred shares and limited partnership in Dexior (SVG) Ltd. and Dexior Centrepoint Limited Partnership and should be advanced against those other entities.

**20** In terms of the claims in paragraph 3(f), these should be disallowed as they are so closely connected with the underlying equity claim that they should be treated as such and should be disallowed.

See for example: *Blue Range* and *Merit Energy*.

**Conclusion**

**21** The Trustee's is authorized to disallow the claims that he has identified in this application.

D.M. MASUHARA J.

cp/e/qlrds/qlvxw/qlced/qlhcs

# TAB 12

*Case Name:*

**National Bank v. Merit Energy Ltd.**

**IN THE MATTER OF the bankruptcy of Merit Energy Ltd.
Between
Larry Delf, on behalf of himself, and all other members of a class having a claim against the defendants, Merit Energy Ltd., Duncan A. Chisholm, Kent J. Edinga, John W. Ferguson, David D. Johnson, John P. Kaumeyer, Lawrence F. Walter, First Energy Capital Corp., Dundee Securities Corporation, Peters & Co. Limited, Nesbitt Burns Inc., Newcrest Capital Inc., RBC Dominion Securities Inc., Bunting Warburg Dillon Read Inc., Price Waterhouse Coopers LLP, appellants (plaintiffs), and
Merit Energy Ltd., respondent (defendant)**

[2002] A.J. No. 6

2002 ABCA 5

[2002] 3 W.W.R. 215

317 A.R. 319

Docket: 01-00332

Alberta Court of Appeal
Calgary, Alberta

**Côté, McFadyen and Costigan JJ.A.**

Heard: January 7, 2002.
Oral judgment: January 7, 2002. Filed: January 11, 2002.

(4 paras.)

On appeal from a portion of the judgment and order of Lovecchio J. Dated and entered August 17, 2001.

**Counsel:**

W.E. McNally, for the appellants.
F.R. Dearlove and C.D. Simard, for the respondent.

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MEMORANDUM OF JUDGMENT
DELIVERED FROM THE BENCH

The judgment of the Court was delivered by

1 CÔTÉ J.A. (orally):-- The very full reasons of the chambers judge are found at 2001 ABQB 583, and set out the facts and issues sufficiently.

2 In our view, the tests used by the chambers judge to characterize were the appropriate ones. And reinforcing that view is the applicable standard of review. Since the question is applying an established legal test to a novel fact situation, we owe considerable deference to the chambers judge.

3 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.

4 The appeal is dismissed.

CÔTÉ J.A.

cp/i/qlrds

# TAB 13

*Case Name:*

# ROI Fund Inc. v. Gandi Innovations Ltd.

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

**[2011] O.J. No. 3827**

**2011 ONSC 5018**

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

**2011 CarswellOnt 8590**

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

Court File No. 09-CL-8172

Ontario Superior Court of Justice
Commercial List

**F.J.C. Newbould J.**

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

(62 paras.)

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

Motion by the Monitor for the Gandi Group for advice and directions regarding indemnity claims made against the Group. The Gandi Group was under creditor protection. The Monitor was appointed in May

2009. The business and assets of the Group were sold with court approval. The Monitor held the proceeds for eventual distribution to unsecured creditors pursuant to a plan of compromise and arrangement. The indemnity claims arose from the 2007 reorganization of the Group's business structure. The claimants were officers and board members of Gandi Holdings. A lender advanced $75 million by way of debt and equity to the Group. The indemnity claimants were party to the advance in their personal capacities. In 2009, the lender commenced arbitration proceedings against the claimants for the total of the advance. The claimants asserted an entitlement to indemnification by the Group in respect of any award of damages which may be made against them in the arbitration together with all legal fees incurred in defending the arbitration. The claimants' proofs of claim relied on indemnity provisions set out in the limited liability company agreement and a separate indemnification made by Gandi Holdings at the time of the lender's advance. In 2011, the Monitor disallowed the claims on the basis that any claim would be made solely against Gandi Holdings rather than against other entities in the Group.

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

**Statutes, Regulations and Rules Cited:**

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

**Counsel:**

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

Mathew Halpin and Evan Cobb, for TA Associates Inc.

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

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## ENDORSEMENT

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

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

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

**Arbitration proceedings and indemnity claims**

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

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

(i) an equity investment in the amount of US $50 million made pursuant to the terms of a Membership Interest Purchase Agreement in respect of Gandi Holdings dated as of September 12, 2007 made between, among others, Gandi Holdings, TA Associates and the Claimants in their personal capacities; and

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

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

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

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

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

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

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

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

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

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

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

**Issues**

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

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

**Discussion**

**(a) Indemnity agreements**

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

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

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

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

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

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

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

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

**24** The date of September 12, 2007, said to be the date that all of the entities in the Gandi Group signed indemnities in favour of each of the claimants, was the date of the investment by TA Associates in which it purchased a membership interest in Gandi Holdings only. Representatives of TA Associates received identical indemnities from Gandi Holdings. There is no evidence that any indemnities from any of the other Gandi Group entities were made at that time. To the contrary, the Membership Interest Purchase Agreement under which TA Associates purchased its membership interest in Gandi Holdings contained as a condition to closing a requirement that Gandi Holdings sign an indemnification agreement. The indemnification was only to be given by Gandi Holdings. There was no requirement for an indemnity to be given by any other entity in the Gandi Group,.

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

**(b) Memorandum and articles of Gandi Hold Co**

**26** In the course of its investigation, the Monitor did locate an indemnity granted by Gandi Hold Co in its Memorandum and Articles in favour of its directors and officers. Those articles contain an indemnity

in the same terms as the indemnity in the Gandi Innovations Limited articles, as discussed below. As the Monitor does not seek a determination regarding indemnities given by Gandi Hold Co, I need not discuss whether one or more of the Claimants is entitled to be indemnified by these articles.

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

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

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

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

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

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

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

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

**33** It is also argued that the board of managers (the Delaware concept of a board of directors) of Gandi Holdings operated the subsidiaries as if they were officers and directors of the subsidiaries. Again, there is no documentary evidence of that and no evidence from any of the Claimants to support the assertion. While Hary Gandy may have operated the business in a functional sense, that does not

mean that he was acting as an officer or director of any subsidiary in the corporate sense. This is not mere semantics. TA Associates made a large investment, and one of the corporate documents provided on closing was the Nova Scotia Registry of Joint Stock Companies that showed only James Gandy as an officer and director. If all of the Claimants are entitled to be indemnified by Gandi Innovations Limited, it will impact the claim of TA Associates in the CCAA proceedings.

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

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

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

### (d) Other Gaudi Group entities

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

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

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

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

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

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

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

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

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

**45** Whether or not Ms. Garay was a disinterested or proper member of the board of management of Gandi Holdings, the minute states that she voted to follow the advice of corporate counsel. At the next

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

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

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

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

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

**48** Pursuant to the terms of the Initial Order, the Monitor was required to approve all expenditures over $10,000 before payment was made. The Monitor approved payment of legal fees to counsel for the Gandi Group on the general understanding that such fees were incurred by the Gandi Group in connection with the Gandi Group's insolvency proceeding and for general corporate work for the Gandi Group.

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

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

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

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

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

**53** Section 6(8) of the CCAA provides:

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

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

"equity claim" means a claim that is in respect of an equity interest, including a claim for, among others,

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

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

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

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

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

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

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

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

> This treatment also has been held to encompass fraudulent misrepresentation claims advanced by a shareholder seeking to recover his investment: *Re Blue Range Resource Corp.*, [2000] A.J. No. 14. In that case, Romaine J. held that the alleged loss derived from and was inextricably intertwined with the shareholder interest. Similarly, in the United States, the Second Circuit Court of Appeal in *Re Stirling Homex Corp.* concluded that shareholders, including those who had allegedly been defrauded, were subordinate to the general creditors when the company was insolvent.

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

**Order**

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

F.J.C. NEWBOULD J.

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# TAB 14

*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.

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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**

<u>The Test</u>

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.

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# TAB 15

# 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*

# 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

## S. Subordination of Equity Claims

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

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

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

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

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

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

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

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

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

# TAB 16

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

## Proposed Wording

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

## Rationale

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

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

## Present Law

None.

## Bill Clause No. 105
## Section No. CCAA s.2
## Topic: Definitions

### Proposed Wording

**"equity claim" means a claim that is in respect of an equity interest, including a claim for, among others,**

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

**"equity interest" means**

- **(*a*) in the case of a 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.**

### Rationale

The definition of "**equity claim**" is added to provide greater clarity in subsequent provisions that deal with the rights of shareholders. An equity claim is defined to include any claim that is related to an equity interest.

The definition of "**equity interest**" is added to provide greater clarity in subsequent provisions that deal with the rights of shareholders. An equity interest is defined to include shares in corporations and units in income trusts and the right to acquire those except where the right is derived from a debt that is convertible into a share or unit. For example, a debenture witnessing a debt obligation that may, at the option of the holder, be converted into equity, should not be considered an equity interest - unless the holder has taken the steps necessary to have the conversion occur.

### Present Law

None.

# TAB 17

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

*Janis Sarra**,†

*National Centre for Business Law, University of British Columbia Faculty of Law, Vancouver, Canada*

## 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]

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

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

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

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

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

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

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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]

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*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

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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

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*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]

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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)(1).
269. The *Bankruptcy Basics* book issued by the Administrative Office of the U.S. Courts specifies that there are historical reasons for using an adversary proceeding, and that *SIPA* specifies that certain features under the *Bankruptcy Code* are applicable in *SIPA* proceedings, *supra*, note 254 at 56.
270. *SIPA*, at 15 U.S.C. §§ 78eee(b)(6)(A) and (B).
271 *Bankruptcy Basics supra*, note 254 at 57.

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by the trustee. Non-customer claims are handled as in an asset case. Costs and expenses, and priorities of distribution from the estate, are allowed as provided in section 726 of Title 11. Funds advanced by SIPC to the trustee for costs and expenses are recouped from the estate, to the extent that there is any estate, pursuant to section 507 of Title 11.

The trustee's powers under a *SIPA* liquidation are almost identical to those of a trustee in bankruptcy.[272] The trustee has responsibility for investigating the acts, conduct, and condition of the debtor securities firm and making a report to the court.[273] The trustee also reports periodically on its progress in distributing cash and securities to customers.[274]

The *SIPA* requires the SIPC to make advances to the trustee in order to satisfy claims, either in the form of cash to customers with claims or to purchase securities to satisfy net equity claims in lieu of cash, including the administrative costs of meeting these claims, up to a maximum of U.S. $500 000 per customer.[275] The SIPC can elect in particular circumstances to undertake direct payment to customers outside of bankruptcy proceedings; specifically, where the claims of all customers aggregate less than U.S. $250 000, the debtor is financially distressed as defined by law and the cost to the SIPC for a direct payment process is less than for liquidation through the courts.[276]

While there was only one firm failure in 2005 in which the SIPC had to intervene, in the past 35 years, it has commenced 314 proceedings of which 283 were completed by the end of 2005.[277] While not all proceedings were bankruptcy proceedings, all did involve firms in financial difficulty. Under the regime, the exchanges, the SEC, and the National Association of Securities Dealers report to SIPC concerning broker-dealers that are insolvent or approaching financial distress. If SIPC determines that it is necessary to act, it applies to a Federal district court for the appointment of a trustee.[278] In some circumstances, SIPC may pay customer claims directly as advances. Since the *SIPA* was enacted, cash and securities distributed for customers of broker-dealers in financial difficulty have totaled U.S. $14.1 billion, of which U.S. $13.8 billion came from debtors' estates.[279]

Customer-related property of the debtor is allocated in the following order: first to SIPC in repayment of any advances made to the extent they were used to recover

272. Those powers vested in a Chapter 7 U.S. *Bankruptcy Code* trustee.

273. *SIPA*, 15 U.S.C. §78fff-1(b)(2). The trustee also reports to SIPC and other persons as the court may direct.

274. *SIPA*, 15 U.S.C. §78fff-1(c).

275. *Bankruptcy Basics, supra*, note 254 at 59; 15 U.S.C. §78fff-3(a). If part of the claim is for cash, the total amount advanced cannot exceed USD 100 000, 15 U.S.C. §78fff-3(a)(1).

276. *SIPA*, 15 U.S.C. §78fff-4(a). The court could still be utilized to resolve disputes, but the process remains a transaction between the SIPC and the debtor's customers, without the expense of a trustee and court proceedings.

277. Securities Investor Protection Corporation, *2005 Annual Report, supra*, note 263 at 6. Twenty-six involved pending litigation matters and five involved claims still being processed. The one proceeding for 2005 was Austin Securities Inc. 314 represents less than 1% of the securities firms and broker-dealers in the U.S. In *Stephenson vs. Deutsche Bank AG, Deutsche Bank Securities Inc., Deutsche Bank Securities Limited, Wayne Breedon et al, Case No. CV02-4845 RHK/AJB (D. Minn.)* the trustee sued the Deutsche Bank-related entities and a Deutsche Bank stock-loan trader and others, in connection with an alleged massive securities fraud. The suit was joined by Ferris Baker Watts, Inc., E*Trade Securities, LLC, CIBC World Markets, Inc. and other securities firms. The trustee reached a settlement at a settlement conference before the magistrate judge, including agreement to withdraw claims, paying the trustee USD 147.5 million in cash. The settlement was approved by the bankruptcy court, and as a result of the settlement all the claims were to be paid in full; *SIPC vs. MJK Clearing Inc.*, Adv. Proc. No. 01-4257 RJK (Bankr. D. Minn. Jan. 18, 2006). The trustee also reached agreement with E*Trade with respect to the competing claims they both had in the bankruptcy case of Native Nations Securities, Inc., *ibid.* at 10.

278. *Ibid.* at 4.

279. *Ibid.*

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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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# TAB 18

Second Session
Thirty-ninth Parliament, 2007

SENATE OF CANADA

*Proceedings of the Standing Senate Committee on*

# Banking, Trade and Commerce

*Chair:*
The Honourable W. DAVID ANGUS

Wednesday, November 28, 2007 (in camera)
Thursday, November 29, 2007

**Issue No. 2**

**Consideration of a draft agenda (future business)
and
First meeting on:**

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

APPEARING:
The Honourable Jean-Pierre Blackburn, P.C., M.P.,
Minister of Labour
Colin Carrie, M.P.,
Parliamentary Secretary to the Minister of Industry

WITNESSES:
*(See back cover)*

Deuxième session de la
trente-neuvième législature, 2007

SÉNAT DU CANADA

*Délibérations du Comité sénatorial permanent des*

# Banques et du commerce

*Président :*
L'honorable W. DAVID ANGUS

Le mercredi 28 novembre 2007 (à huis clos)
Le jeudi 29 novembre 2007

**Fascicule nº 2**

**Étude d'un projet d'ordre du jour (travaux futurs)
et
Première réunion concernant :**

Le projet de loi C-12, Loi modifiant la Loi sur la faillite et l'insolvabilité, la Loi sur les arrangements avec les créanciers des compagnies, la Loi sur le Programme de protection des salariés et le chapitre 47 des Lois du Canada (2005)

COMPARAISSENT :
L'honorable Jean-Pierre Blackburn, C.P., député,
ministre du Travail
Colin Carrie, député,
secrétaire parlementaire du ministre de l'Industrie

TÉMOINS :
*(Voir à l'endos)*

45052

THE STANDING SENATE COMMITTEE ON BANKING, TRADE AND COMMERCE

The Honourable W. David Angus, *Chair*

The Honourable Yoine Goldstein, *Deputy Chair*

and

The Honourable Senators:

| | |
|---|---|
| Biron | * LeBreton, P.C. (or Comeau) |
| Eyton | Meighen |
| Fitzpatrick | Moore |
| Harb | Peterson |
| * Hervieux-Payette, P.C. (or Tardif) | Ringuette |
| | Tkachuk |

*Ex officio members

(Quorum 4)

*Changes in membership of the committee:*

Pursuant to rule 85(4), membership of the committee was amended as follows:

The name of the Honourable Senator Moore was added (*November 20, 2007*).

The name of the Honourable Senator Poy substituted for that of the Honourable Senator Cowan (*November 21, 2007*).

The name of the Honourable Senator Chaput substituted for that of the Honourable Senator Massicotte (*November 26, 2007*).

Substitution pending for the Honourable Senator Poy (*November 26, 2007*).

The name of the Honourable Senator Massicotte substituted for that of the Honourable Senator Chaput (*November 26, 2007*).

The name of the Honourable Senator Peterson substituted for that of the Honourable Senator Massicotte (*November 29, 2007*).

LE COMITÉ SÉNATORIAL PERMANENT DES BANQUES ET DU COMMERCE

*Président :* L'honorable W. David Angus

*Vice-président :* L'honorable Yoine Goldstein

et

Les honorables sénateurs :

| | |
|---|---|
| Biron | * LeBreton, C.P. (ou Comeau) |
| Eyton | Meighen |
| Fitzpatrick | Moore |
| Harb | Peterson |
| * Hervieux-Payette, C.P. (ou Tardif) | Ringuette |
| | Tkachuk |

*Membres d'office

(Quorum 4)

*Modifications de la composition du comité :*

Conformément à l'article 85(4) du Règlement, la liste des membres du comité est modifiée, ainsi qu'il suit :

Le nom de l'honorable sénateur Moore est ajouté (*le 20 novembre 2007*).

Le nom de l'honorable sénateur Poy est substitué à celui de l'honorable sénateur Cowan (*le 21 novembre 2007*).

Le nom de l'honorable sénateur Chaput est substitué à celui de l'honorable sénateur Massicotte (*le 26 novembre 2007*).

Remplacement à venir pour l'honorable sénateur Poy (*le 26 novembre 2007*).

Le nom de l'honorable sénateur Massicotte est substitué à celui de l'honorable sénateur Chaput (*le 26 novembre 2007*).

Le nom de l'honorable sénateur Peterson est substitué à celui de l'honorable sénateur Massicotte (*le 29 novembre 2007*).

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**ORDER OF REFERENCE**

Extract from the *Journals of the Senate* of Thursday, November 15 2007:

Second reading 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 Honourable Senator Meighen moved, seconded by the Honourable Senator Eyton, that the bill be read the second time.

After debate,

The question being put on the motion, it was adopted.

The bill was then read the second time.

The Honourable Senator Meighen moved, seconded by the Honourable Senator Keon, that the bill be referred to the Standing Senate Committee on Banking, Trade and Commerce.

The question being put on the motion, it was adopted.

**ORDRE DE RENVOI**

Extrait des *Journaux du Sénat* du jeudi 15 novembre 2007 :

Deuxième lecture du projet de loi C-12, Loi modifiant la Loi sur la faillite et l'insolvabilité, la Loi sur les arrangements avec les créanciers des compagnies, la Loi sur le Programme de protection des salariés et le chapitre 47 des Lois du Canada (2005).

L'honorable sénateur Meighen propose, appuyé par l'honorable sénateur Eyton, que le projet de loi soit lu pour la deuxième fois.

Après débat,

La motion, mise aux voix, est adoptée.

Le projet de loi est alors lu pour la deuxième fois.

L'honorable sénateur Meighen propose, appuyé par l'honorable sénateur Keon, que le projet de loi soit renvoyé au Comité sénatorial permanent des banques et du commerce.

La motion, mise aux voix, est adoptée.

*Le greffier du Sénat,*

Paul C. Bélisle

*Clerk of the Senate*

## MINUTES OF PROCEEDINGS

OTTAWA, Wednesday, November 28, 2007
(3)

[*English*]

The Standing Senate Committee on Banking, Trade and Commerce met in camera at 4:10 p.m., this day, in room 505, Victoria Building, the Chair, the Honourable W. David Angus, presiding.

*Members of the committee present*: The Honourable Senators Angus, Biron, Fitzpatrick, Goldstein, Meighen, Moore and Ringuette (7).

*In attendance:* June Dewetering and Philippe Bergevin, Analysts, Parliamentary Information and Research Services, Library of Parliament.

Pursuant to rule 92(2)(e), the committee proceeded to study its draft agenda (future business).

It was agreed that the committee hear more witnesses, as well as to hold public hearings in Vancouver, Calgary, Halifax, Montreal and Toronto, concerning the study on issues dealing with interprovincial barriers to trade in Canada.

It was agreed that the hearings concerning the study of Bill C-12 will take priority after the holiday break.

It was agreed that, in the event that it is referred to the committee shortly, hearings concerning the study of Bill C-10 will be held before the holiday break.

It was agreed that the fact-finding trip to Washington be postponed to the spring.

Pursuant to rule 92(2)(f), the committee considered draft reports.

The committee considered the following draft legislative budget application:

| | |
|---|---|
| Professional and Other Services | $ 34,000 |
| Transportation and Communications | $ 0 |
| All Other Expenditures | $ 8,000 |
| **TOTAL** | **$ 42,000** |

The Honourable Senator Biron moved:

That the legislative budget application in the amount of $42,000 be adopted and that the chair present the same to the Standing Committee on Internal Economy, Budget and Administration.

The question being put on the motion, it was adopted.

The committee considered the following draft special study budget application (present state of the domestic and international financial system):

| | |
|---|---|
| Professional and Other Services | $ 42,300 |
| Transportation and Communications | $ 80,025 |
| All Other Expenditures | $ 2,000 |
| **TOTAL** | **$ 124,325** |

## PROCÈS-VERBAUX

OTTAWA, le mercredi 28 novembre 2007
(3)

[*Traduction*]

Le Comité sénatorial permanent des banques et du commerce se réunit aujourd'hui à huis clos, à 16 h 10, dans la salle 505 de l'édifice Victoria, sous la présidence de l'honorable W. David Angus (*président*).

*Membres du comité présents :* Les honorables sénateurs Angus, Biron, Fitzpatrick, Goldstein, Meighen, Moore et Ringuette (7).

*Aussi présents :* June Dewetering et Philippe Bergevin, analystes, Service d'information et de recherche parlementaires, Bibliothèque du Parlement.

Conformément à l'alinéa 92(2)e) du Règlement, le comité examine son ébauche de programme (travaux futurs).

Il est convenu que le comité entende davantage de témoins et tienne également des séances publiques à Vancouver, Calgary, Halifax, Montréal et Toronto au sujet de l'étude des questions relatives aux obstacles interprovinciaux au commerce au Canada.

Il est convenu que les audiences concernant l'étude du projet de loi C-12 se feront en priorité après le congé des Fêtes.

Si le projet de loi C-10 est renvoyé au comité très prochainement, il est convenu que les audiences pour son étude se tiendront avant le congé des Fêtes.

Il est convenu que le voyage d'information à Washington soit reporté au printemps.

Conformément à l'alinéa 92(2)f) du Règlement, le comité examine des ébauches de rapports.

Le comité examine le budget suivant pour l'étude des projets de loi :

| | |
|---|---|
| Services professionnels et autres | 34 000 $ |
| Transports et communications | 0 $ |
| Autres dépenses | 8 000 $ |
| **TOTAL** | **42 000 $** |

L'honorable sénateur Biron propose :

Que le budget pour l'étude des projets de loi, se chiffrant à 42 000 $, soit adopté, et que le président le soumette au Comité permanent de la régie interne, des budgets et de l'administration.

La question, mise aux voix, est adoptée.

Le comité examine le budget suivant pour l'étude spéciale (situation actuelle du régime financier canadien et international) :

| | |
|---|---|
| Services professionnels et autres | 43 200 $ |
| Transports et communications | 80 025 $ |
| Autres dépenses | 2 000 $ |
| **TOTAL** | **124 325 $** |

The Honourable Senator Moore moved:

That the special study budget application (present state of the domestic and international financial system) in the amount of $124,325 be adopted and that the chair present the same to the Standing Committee on Internal Economy, Budget and Administration.

The question being put on the motion, it was adopted.

The committee considered the following draft special study budget application (issues dealing with interprovincial barriers to trade in Canada):

| | |
|---|---|
| Professional and Other Services | $ 28,000 |
| Transportation and Communications | $ 11,625 |
| All Other Expenditures | $ 300 |
| **TOTAL** | **$ 39,925** |

The Honourable Senator Ringuette moved:

That the special study budget application (issues dealing with interprovincial barriers to trade in Canada) be adopted with the addition of necessary funds to include public hearings in Calgary, Vancouver, Halifax, Montreal and Toronto, and that the chair present the revised budget to the Standing Committee on Internal Economy, Budget and Administration.

The question being put on the motion, it was adopted.

At 5:20 p.m., the committee adjourned to the call of the chair.

*ATTEST:*

L'honorable sénateur Moore propose :

Que le budget pour l'étude spéciale (situation actuelle du régime financier canadien et international) d'un montant de 124 325 $ soit adopté, et que le président le soumette au Comité permanent de la régie interne, des budgets et de l'administration.

La question, mise aux voix, est adoptée.

Le comité examine le budget pour l'étude spéciale suivante (questions relatives aux obstacles interprovinciaux au commerce au Canada) :

| | |
|---|---|
| Services professionnels et autres | 28 000 $ |
| Transports et communications | 11 625 $ |
| Autres dépenses | 300 $ |
| **TOTAL** | **39 925 $** |

L'honorable sénateur Ringuette propose :

Que le budget pour l'étude spéciale (questions relatives aux obstacles interprovinciaux au commerce au Canada) soit adopté, et que soient ajoutés les fonds nécessaires pour tenir des audiences publiques à Calgary, Vancouver, Halifax, Montréal et Toronto, et que le président soumette le budget révisé au Comité permanent de la régie interne, des budgets et de l'administration.

La question, mise aux voix, est adoptée.

À 17 h 20, le comité suspend ses travaux jusqu'à nouvelle convocation de la présidence.

*ATTESTÉ :*

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OTTAWA, Thursday, November 29, 2007
(4)

[*English*]

The Standing Senate Committee on Banking, Trade and Commerce met at 10:50 a.m., this day, in room 9, Victoria Building, the Chair, the Honourable W. David Angus, presiding.

*Members of the committee present*: The Honourable Senators Angus, Biron, Goldstein, Harb, Meighen, Moore, Peterson and Ringuette (8).

*In attendance:* June Dewetering and Philippe Bergevin, Analysts, Parliamentary Information and Research Service, Library of Parliament.

*Also in attendance:* The official reporters of the Senate.

Pursuant to the order of reference adopted by the Senate on November 15, 2007, the committee began its study of the 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.

OTTAWA, le jeudi 29 novembre 2007
(4)

[*Traduction*]

Le Comité sénatorial permanent des banques et du commerce se réunit aujourd'hui, à 10 h 50, dans la salle 9 de l'édifice Victoria, sous la présidence de l'honorable W. David Angus (*président*).

*Membres du comité présents :* Les honorables sénateurs Angus, Biron, Goldstein, Harb, Meighen, Moore, Peterson et Ringuette (8).

*Aussi présents :* June Dewetering et Philippe Bergevin, analystes, Service d'information et de recherche parlementaires, Bibliothèque du Parlement.

*Également présents :* Les sténographes officiels du Sénat.

Conformément à l'ordre de renvoi adopté par le Sénat le 15 novembre 2007, le comité entreprend son étude du projet de loi C-12, Loi modifiant la Loi sur la faillite et l'insolvabilité, la Loi sur les arrangements avec les créanciers des compagnies, la Loi sur le Programme de protection des salariés et le chapitre 47 des Lois du Canada (2005).

*APPEARING:*

The Honourable Jean-Pierre Blackburn, P.C., M.P., Minister of Labour;

Colin Carrie, M.P., Parliamentary Secretary to the Minister of Industry.

*WITNESSES:*

*Labour Program, Human Resources and Social Development Canada:*

Munir A. Sheikh, Deputy Minister of Labour;

Sylvie Heartfield, Chief, Policy Development.

*Industry Canada:*

Roger Charland, Senior Director, Corporate and Insolvency Law Policy and Internal Trade;

Matthew Dooley, Senior Project Leader, Corporate and Insolvency Law Policy and International Trade.

*Human Resources and Social Development Canada:*

Rosaline Frith, Director General, Canada Student Loans Program;

John Hemingway, Program Analyst, Canada Student Loans Program.

At 11 a.m., the Honourable Senator Goldstein noted for the record that while he has had dealings with matters of bankruptcy and insolvency professionally, he is satisfied that he does not have a private interest in the committee's current study pursuant to the *Conflict of Interest Code for Senators* and intends to participate in deliberations on this matter.

At 11:05 a.m., Mr. Blackburn made a statement and, together with the other witnesses, answered questions.

At 11:50 a.m., Mr. Carrie made a statement and, together with the other witnesses, answered questions.

At 12:55 p.m., the committee adjourned to the call of the chair.

*ATTEST:*

*COMPARAISSENT :*

L'honorable Jean-Pierre Blackburn, C.P., député, ministre du Travail;

Colin Carrie, député, secrétaire parlementaire du ministre de l'Industrie.

*TÉMOINS :*

*Programme du travail, Ressources humaines et Développement social Canada :*

Munir A. Sheikh, sous-ministre du Travail;

Sylvie Heartfield, chef en matière de politiques.

*Industrie Canada :*

Roger Charland, directeur principal, Politique du droit corporatif, de l'insolvabilité et du commerce intérieur;

Matthew Dooley, chef principal de projet, Politique du droit corporatif, de l'insolvabilité et du commerce intérieur.

*Ressources humaines et Développement social Canada :*

Rosaline Frith, directrice générale, Programme canadien de prêts aux étudiants;

John Hemingway, analyste de programme, Programme canadien de prêts aux étudiants.

À 11 heures, l'honorable sénateur Goldstein indique — pour que cela figure au compte rendu — que même s'il s'est occupé, dans le cadre de ses activités professionnelles, de questions relatives aux faillites et à l'insolvabilité, il est satisfait de voir qu'il n'a pas d'intérêt privé dans l'étude que mène actuellement le comité, conformément au *Code régissant les conflits d'intérêts des sénateurs*, et qu'il entend donc participer aux délibérations.

À 11 h 5, M. Blackburn fait une déclaration puis, aidé des autres témoins, répond aux questions.

À 11 h 50, M. Carrie fait une déclaration puis, aidé des autres témoins, répond aux questions.

À 12 h 55, le comité suspend ses travaux jusqu'à nouvelle convocation de la présidence.

*ATTESTÉ :*

*La greffière du comité,*

Line Gravel

*Clerk of the Committee*

## EVIDENCE

OTTAWA, Thursday, November 29, 2007

The Standing Senate Committee on Banking, Trade and Commerce, to which was referred 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, met this day at 10:50 am. to give consideration to the bill.

**Senator W. David Angus** (*Chair*) in the chair.

[*English*]

**The Chair:** Good morning. This is an official meeting of the Standing Senate Committee on Banking, Trade and Commerce. My name is Senator David Angus. I am the chairman of the committee, and I am from Quebec. Senator Goldstein, the deputy chairman, is also from Quebec. Senator Meighen has a foot in Ontario and Quebec. Senator Moore is from Halifax, Nova Scotia. Senator Harb, a former distinguished member of Parliament, is from the Ottawa region. From Saskatchewan, we have Senator Peterson, and Senator Ringuette is from New Brunswick. Our clerk is Dr. Line Gravel, and the others you see are our distinguished and able assistants from the parliamentary library.

Welcome to our witnesses. I would indicate that we are not only ourselves in this room 9 of the Victoria Building but we are also on the World Wide Web. Our deliberations are going out on webcast and will subsequently be broadcast on the network of CPAC.

[*Translation*]

Today, the Standing Senate Committee on Banking, Trade and Commerce will begin its hearings on 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).

Bill C-12 is a reprint of Bill C-62 that was brought forward during the first session of the 39th Parliament and was adopted at third reading by the House of Commons on June 14, 2007. The bill was sent to our committee on November 15, 2007.

[*English*]

In November 2003, following a very in-depth study as part of an overall reform of Canada's framework legislation on bankruptcy and insolvency, CCAA and related statutes being carried out by the stakeholders, we did our own study. We were ably assisted by one of Canada's leading bankruptcy counsel, as he then was in the private sector, our Senator Goldstein, who has since been summoned to the Senate and has reached his distinguished position as deputy chair of the committee. I am sure he will be talking more about that aspect later. As a result of that study, we produced a report to the Senate and to the ministers involved, the Minister of Industry and the Minister of

## TÉMOIGNAGES

OTTAWA, le jeudi 29 novembre 2007

Le Comité sénatorial permanent des banques et du commerce à qui on a renvoyé le projet de loi C-12, Loi modifiant la Loi sur la faillite et l'insolvabilité, la Loi sur les arrangements avec les créanciers des compagnies, la Loi sur le programme de protection des salariés et le chapitre 47 des Lois du Canada, 2005, se réunit aujourd'hui à 10 h 50 pour étudier le projet de loi.

**Le sénateur W. David Angus** (*président*) occupe le fauteuil.

[*Traduction*]

**Le président :** Bonjour. Cette réunion est une réunion officielle du Comité sénatorial permanent des banques et du commerce. Je suis le sénateur David Angus. Je suis président du comité et je viens du Québec. Le sénateur Goldstein, le vice-président, vient également du Québec. Le sénateur Meighen chevauche en quelque sorte l'Ontario et le Québec. Le sénateur Moore vient d'Halifax, en Nouvelle-Écosse. Le sénateur Harb, qui a été un grand député, vient de la région d'Ottawa. Le sénateur Peterson, vient de la Saskatchewan et le sénateur Ringuette, du Nouveau-Brunswick. Notre greffière est Mme Line Gravel et les autres personnes que vous voyez autour de nous sont nos adjoints fort compétents de la Bibliothèque du Parlement.

Je tiens à souhaiter la bienvenue à nos témoins. En fait nos délibérations ne se limiteront pas à la salle 9 de l'édifice Victoria car elles sont également diffusées sur Internet. Nos délibérations seront diffusées en webémission et seront télédiffusées plus tard au réseau CPAC.

[*Français*]

Aujourd'hui, le Comité sénatorial permanent des banques et du commerce débute ses audiences sur le projet de loi C-12, Loi modifiant la Loi sur la faillite et l'insolvabilité, la Loi sur les arrangements avec les créanciers des compagnies, la Loi sur le Programme de protection des salariés et le chapitre 47 des Lois du Canada (2005).

Le projet de loi C-12 est une réimpression du projet de loi C-62 proposé à la première session de la 39e législature et adopté en troisième lecture par la Chambre des communes le 14 juin 2007. Le projet de loi a été renvoyé à notre comité le 15 novembre 2007.

[*Traduction*]

En novembre 2003, à la suite d'une étude très approfondie dans le cadre d'une réforme générale des lois canadiennes en matière de faillite et d'insolvabilité, de la Loi sur les arrangements avec les créanciers des compagnies et des lois connexes à laquelle ont procédé les intervenants, notre comité a effectué sa propre étude. Nous avons dans le cadre de ces travaux reçu l'aide d'un des principaux avocats spécialisés en faillite, qui était alors dans le secteur privé, notre sénateur Goldstein, qui a depuis été nommé au Sénat et qui est aujourd'hui vice-président du comité. Je suis convaincu qu'il vous donnera de plus amples détails tout à l'heure. À la suite de cette étude, nous avons rédigé un rapport

Labour. In our report, we made some 53 recommendations related to consumer insolvency, commercial insolvency and administrative and procedural issues.

On November 25, 2005, Bill C-55 received Royal Assent with too much haste, if you will. When it reached this committee with an exhortation to quickly review it and report it back without amendments in view of a forthcoming election, the Banking Committee said, "How can we carry out our duty of serious and sober second thought in review of this bill? We cannot report this back without amendment because we have officials telling us they have some 68 amendments to propose to the bill." It was not ready for prime time, in other words. The bill was passed under the then government and under Minister Emerson and Minister Fontana, I believe, as principal ministers involved in Industry and Labour.

How did we resolve this? The government was asking for the bill. The then chairman, my predecessor, Senator Grafstein, and myself and our colleagues on the committee deliberated and came to a compromised solution, which was if the Minister of Industry, Mr. Emerson, and his colleague in the Department of Labour, as well as the Leader of the Government in the Senate, Senator Austin, would give the committee a letter and file the letter in the Senate and in the House of Commons to be a formal record, we would return the bill back on the condition that it would not be proclaimed before the Banking Committee had an opportunity to review it. Therefore, it became a bill embedded in chapter 47 of the Statutes of Canada of that year but not in force. The bankruptcy and insolvency community, as well as the labour movement, who were waiting on these provisions of law and this overhaul of the framework legislation, were left in a terrible dilemma. The review and study had taken place, but there was no new legislation.

The new government came in. We drew the situation to their attention. Minister Blackburn came on the scene, as did Maxime Bernier as Minister of Industry, and Minister Blackburn was asked to sponsor the bill. All kinds of technical problems raised their heads, and I will not go into detail.

The bottom line was that we were able to get the bill as originally drafted back to this committee in the same form or, indeed with amendments as may have been required. It has found its way to legislative heaven and is here in the form of Bill C-12. It includes a series of amendments to the original Bill C-55.

There were some amendments enacted into law in the last Parliament in Bill C-52, which dealt with the budget. It dealt with certain urgent matters of concern to the financial markets dealing with structured derivative products. Legal opinions were needed

qui a été déposé au Sénat et présenté aux ministres concernés, le ministre de l'Industrie et le ministre du Travail. Nous avons formulé, dans notre rapport, quelque 53 recommandations touchant l'insolvabilité des consommateurs et des entreprises ainsi que des questions de procédure et d'administration.

Le 25 novembre 2005, le projet de loi C-55 a reçu la sanction royale, trop rapidement d'ailleurs, si je peux le signaler. Lorsqu'il a été renvoyé à notre comité, on nous avait encouragés à l'étudier très rapidement et à en faire rapport sans modification puisque l'on attendait des élections sous peu. Le comité des banques a alors demandé comment il pouvait dans ces circonstances s'acquitter de sa responsabilité qui est de procéder à un second examen objectif des mesures législatives. Nous avons dit que nous ne pouvions pas faire rapport de cette mesure législative sans modifications simplement parce que les fonctionnaires nous disaient en fait qu'ils avaient 68 modifications à proposer au projet de loi. En fait ce projet de loi n'était pas prêt à être adopté. Il a été adopté suite aux consignes du gouvernement d'alors et si je ne me trompe de deux ministres, le ministre Emerson et le ministre Fontana, responsables de l'Industrie et du Travail.

Comment avons-nous réglé ce problème? Le gouvernement voulait qu'on fasse rapport du projet de loi. Le président d'alors, mon prédécesseur le sénateur Grafstein, moi-même et mes collègues membres du comité avons longuement discuté de la question et en sommes venus à une solution de compromis; ainsi, nous avons dit que si le ministre de l'Industrie, M. Emerson, et son collègue du ministère du Travail, ainsi que le leader du gouvernement au Sénat, le sénateur Austin, étaient disposés à rédiger une lettre qui serait déposée au Sénat et à la Chambre des communes pour qu'il y ait dossier officiel, nous renverrions le projet de loi au Sénat si l'on s'engageait à ne pas promulguer la loi tant que le comité des banques n'aura pas eu l'occasion de l'étudier. Ainsi, le texte du projet de loi a été enchâssé dans le chapitre 47 des Lois du Canada de cette année-là, mais n'a pas été mis en vigueur. Le secteur de l'insolvabilité et des faillites, ainsi que les syndicats, qui attendaient que ces dispositions soient adoptées et qu'on remanie la loi cadre, se sont retrouvés dans une situation plutôt difficile. L'examen avait eu lieu, mais la nouvelle loi n'avait pas été mise en œuvre.

Le nouveau gouvernement est arrivé. Nous lui avons signalé le problème. M. Blackburn a été nommé ministre du Travail, et Maxime Bernier a été nommé ministre de l'Industrie. On a demandé à M. Blackburn de parrainer le projet de loi. Toutes sortes de problèmes techniques ont fait surface, mais je vous ferai grâce des détails.

Le fait est que nous avons pu obtenir que l'on renvoie au comité ce projet de loi dans sa version originale ou modifiée. Alors il nous est revenu sous la forme du projet de loi C-12. Cette nouvelle mesure législative inclut une série de modifications qui avaient été apportées au projet de loi initial, le projet de loi C-55.

Certaines modifications ont été adoptées dans le projet de loi C-52 au cours de l'ancienne législature, et ces modifications concernaient le budget. Et elles portaient sur des questions urgentes pour les marchés financiers qui devaient composer

to enable leverage to take place with these products. Also, certain additional amendments were added at the request of certain non-governmental parties from the province of Quebec.

We now have before us a series of amendments to the original Bill C-55, which came here in 2005. It has passed through the House of Commons and has received second reading in the Senate, and we are now about to commence a detailed and in-depth study of this bill on the understanding that it contains the amendments we would have arrived at had we studied it two or three years ago.

[*Translation*]

This morning, we are beginning our consideration of Bill C-12. It is our pleasure to welcome the Honourable Jean-Pierre Blackburn from Northern Quebec. He is the Minister of Labour and the Minister responsible for the Economic Development Agency of Canada for the Regions of Quebec.

[*English*]

He is accompanied by Mr. Munir Sheikh, Deputy Minister of Labour; Ms. Sylvie Heartfield, Chief, Policy Development; and Dr. Colin Carrie, Member of Parliament for Oshawa and Parliamentary Secretary to Minister of Industry Jim Prentice. Also with him are Mr. Roger Charland, Senior Director, Corporate and Insolvency Law Policy and Internal Trade; Mr. Matthew Dooley, Senior Project Leader, Corporate and Insolvency Law Policy and International Trade; and finally, from Human Resources and Social Development Canada, Ms. Rosaline Frith, Director General, Canada Student Loans Program.

Senator Goldstein would like to make a statement.

**Senator Goldstein:** For the purposes of the record, I believe that I do not have any conflict of interest with respect to the consideration of this bill. However, I have been very active professionally in matters of bankruptcy and insolvency in the past, and I am currently senior counsel — although I have no time to practise — to a firm with offices in Montreal and Toronto which is also active in matters of bankruptcy and insolvency. I do not believe that in any way disqualifies me from dealing with these issues because I have no personal interest, other than a professional interest, in the bill. For the sake of good order and clarity, I thought this declaration should be on the record.

**The Chair:** Thank you, Senator Goldstein. All of those observing our proceedings today should be aware that we are subject to the *Conflict of Interest Code for Senators.* Our Ethics Officer, Mr. Fournier, oversees the code. There are procedures we are obliged to follow, not only for the sake of perception but to obviate real or potential conflicts of interest. For the

avec la question des instruments dérivés. Des avis juridiques s'imposaient si l'on voulait que ces produits puissent avoir un effet de levier financier. De plus, certains intervenants du secteur privé au Québec voulaient que d'autres amendements soient apportés.

Nous sommes donc saisis d'une série de modifications qui ont été apportées au projet de loi initial, le projet de loi C-55, qui nous avait été renvoyé en 2005. Il a été adopté par la Chambre des communes et a franchi l'étape de la deuxième lecture au Sénat. Nous sommes donc sur le point de commencer une étude approfondie de ce projet de loi puisqu'il comporte des amendements que nous aurions suggérés si nous avions eu le temps de l'étudier il y a deux ou trois ans.

[*Français*]

Ce matin, nous allons commencer notre étude du projet de loi C-12. Nous sommes heureux de souhaiter la bienvenue à l'honorable Jean-Pierre Blackburn, du nord du Québec. Il est ministre du Travail et ministre de l'Agence de développement économique du Canada pour les régions du Québec.

[*Traduction*]

Il est accompagné de M. Muni Sheikh, sous-ministre du Travail; Mme Sylvie Heartfield, chef, Développement des politiques, et M. Colin Carrie, député d'Oshawa et secrétaire parlementaire du ministre de l'Industrie, M. Jim Prentice. Nous accueillons également, M. Roger Charland, directeur principal, Politique du droit corporatif, de l'insolvabilité et du commerce intérieur, M. Matthew Dooley, chef principal de projet, Politique du droit corporatif, de l'insolvabilité et du commerce international, et enfin, de Ressources humaines et Développement social Canada, Mme Rosaline Frith, directrice générale, Programme canadien des prêts aux étudiants.

Le sénateur Goldstein désire dire quelques mots.

**Le sénateur Goldstein :** Aux fins du compte rendu, j'aimerais signaler que je ne crois pas avoir de conflits d'intérêts si je participe aux travaux du comité qui étudie ce projet de loi. Cependant, j'ai joué un rôle actif à titre de professionnel en matière de faillite et d'insolvabilité dans le passé, et je suis actuellement avocat principal, quoique je n'aie pas vraiment le temps de pratiquer le droit — d'un cabinet d'avocats qui a des bureaux à Montréal et à Toronto et qui travaille dans le secteur des faillites et de l'insolvabilité. Je ne crois pas que cela m'empêcherait de me pencher à titre de membre du comité sur ces sujets puisque je n'ai aucun intérêt personnel mais uniquement professionnel à cet égard. Mais je voulais, par souci de clarté, officiellement faire le point sur la situation.

**Le président :** Merci, sénateur Goldstein. Pour ceux d'entre vous qui suivent nos délibérations, j'aimerais vous rappeler que nous sommes tous assujettis au *Code régissant les conflits d'intérêts* des sénateurs et que notre agent d'éthique, M. Fournier, en assure l'application. Nous sommes tenus de suivre certaines procédures, pas simplement pour des raisons de perception, mais

integrity of the Senate and that of our own deliberations, Senator Goldstein, that was a very wise move.

pour assurer qu'il n'y a aucun danger de conflit d'intérêts. Sénateur Goldstein, je dois vous remercier d'avoir fait cette sage déclaration parce que cela garantit l'intégrité du Sénat et de nos délibérations.

[*Translation*]

Mr. Blackburn, it is a pleasure, as a senator from Quebec, to welcome you to our committee this morning. Bill C-12 covers an area that is very important for the reasons I stated earlier, but also for other reasons. Obviously, all involved stakeholders are looking forward to this bill.

[*English*]

We look forward to your comments.

[*Translation*]

**Hon. Jean-Pierre Blackburn, P.C., M.P., Minister of Labour:** Thank you, Mr. Chairman. I appreciate the courtesy you have shown me in inviting me to appear before you in order to share my perspective as Minister of Labour and as a representative of our government, because it is on behalf of our government that this bill was tabled.

You are right, Mr. Chairman, in having pointed out the background to this bill because it is true that many people are waiting for it to be passed. We ourselves decided to fast track it in order to bring this bill before the Senate for its final analysis, given that this was preceded by a lengthy process.

This is the second time that the process is starting over. Once again, this morning I had an opportunity to speak with an important union representative who told me that he hoped the Senate would be able to move quickly through the various stages of the bill, without wanting to prejudge its outcome. Of course, everyone is worried that there may be elections at any time now, and because we are a minority government that is always a possibility. People are hoping that this legislation will pass before any elections are triggered. However that is your responsibility; I am only passing on a point of view to you that was given to me.

[*English*]

**The Chair:** Minister, you have touched on a very important matter, which we discussed in some detail last night at an off-the-record committee hearing. We already understand that in addition to the amendments in Bill C-12, the stakeholders have brought to the attention of the officials and the officials have determined on their own that the bill could be further improved. We understand that there is an ongoing review of framework legislation procedure in your department and within Industry Canada. The review might put you in position to say that you are prepared to come back next year with a further small bill of amendments. Perhaps that could be backed up, to give us comfort, by letters from the two ministers involved.

[*Français*]

Monsieur Blackburn, c'est un plaisir, en tant que sénateur du Québec, de vous recevoir devant notre comité ce matin. Le projet de loi C-12 couvre un domaine très important pour les raisons que j'ai mentionnées plus tôt, mais aussi pour d'autres raisons. Il est évident que les parties intéressées ont hâte de recevoir cette loi.

[*Traduction*]

Nous avons hâte d'entendre vos commentaires.

[*Français*]

**L'honorable Jean-Pierre Blackburn, C.P., député, ministre du Travail :** Merci, monsieur le président, j'apprécie la courtoisie que vous avez eue de m'inviter à comparaître devant vous pour vous faire part de mon point de vue en tant que ministre du Travail et représentant de notre gouvernement, puisque c'est au nom de notre gouvernement qu'on a déposé ce projet de loi.

Vous avez raison, monsieur le président, d'avoir relevé l'historique de ce projet de loi, puisqu'il est vrai que beaucoup de gens attendent qu'il soit adopté. Nous-mêmes avons utilisé la voie rapide, pour arriver à déposer à nouveau le projet de loi devant le Sénat, afin qu'il en fasse l'analyse ultime, étant donné qu'il y a déjà eu toute une procédure au préalable.

C'est la deuxième fois que l'on recommence le processus. Ce matin encore, j'ai eu l'occasion de parler avec un représentant d'un grand mouvement syndical qui nous faisait part de son souhait qu'il soit possible pour le Sénat de passer rapidement à travers les étapes du projet de loi, sans vouloir préjuger de ce que seront vos décisions. Tout le monde craint, bien sûr, que des élections arrivent à tout moment — nous sommes un gouvernement minoritaire, c'est toujours possible. Les gens souhaitent que la loi puisse être adoptée avant toute possibilité de déclenchement d'élections. Mais c'est votre responsabilité, je ne fais que vous transmettre un point de vue exprimé par le milieu.

[*Traduction*]

**Le président :** Monsieur le ministre, vous venez d'aborder une question très importante dont nous avons assez longuement traité hier soir lors d'une réunion officieuse du comité. Nous savons déjà qu'outre les modifications proposées dans le projet de loi C-12, les intervenants ont attiré l'attention des fonctionnaires sur un certain nombre d'améliorations pouvant être apportées au projet de loi. Nous avons appris qu'Industrie Canada et votre ministère procèdent actuellement à un examen du cadre législatif. À l'issue de cet examen, il est possible que vous deviez l'an prochain présenter une autre série d'amendements. Dans le but de nous rassurer, les deux ministres visés pourraient peut-être nous transmettre une lettre en ce sens.

I only raise that to get your comments on it. Please carry on with your presentation with the knowledge that we have been focusing on the need for rapid passage and, at the same time, probable need for other amendments.

[*Translation*]

**Mr. Blackburn:** It is in fact always a possibility that you, the members of the Senate, after having analyzed the bill, will express your points of view or suggest certain amendments. That is your prerogative and we understand that fully.

Therefore, Mr. Chairman, I would like to point out that the bill makes changes that are needed to correct some technical flaws that were identified in an earlier bill that the House of Commons passed.

The old Bill C-55, which is now chapter 47 of the Statutes of Canada, 2005, was first introduced in June 2005. Its objective was to modernize Canada's insolvency system by amending the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act, as well as to create the legislative framework for the Wage Earner Protection Program.

Members from all parties understand the goal of chapter 47: to bring much-needed reform to Canada's insolvency regime. As well, it introduced new measures of protection for employees when an employer becomes bankrupt and there are insufficient assets to pay earned wages and vacation pay.

I think everyone would agree that it makes perfect sense to protect employees first and foremost in the case of a bankruptcy. After all, we are talking about their livelihood and that of their family. They should be the first people to be protected.

Chapter 47 passed through both Houses of Parliament quickly and received royal assent in November 2005. It was agreed to pass the legislation as quickly as possible on the understanding that such a complex piece of legislation would require further review to ensure that it would accomplish its main objective without resulting in unintended consequences.

The bill that is now before us represents a major step forward in that review — a review that has included consultation with the stakeholder community. That input has led to recommendations for a number of changes to improve the original legislation. Bill C-12 makes a number of improvements to chapter 47. It addresses the kind of technical flaws that often come up in legislation that breaks new ground, but that need to be corrected.

I would like to reiterate why the Wage Earner Protection Program aspect of the new bill is important and why all senators should support it. The Wage Earner Protection Program is important because it addresses a common problem that can arise

Je voulais simplement que vous confirmiez les renseignements que nous avons obtenus. Veuillez poursuivre votre exposé. Sachez cependant que nous comprenons qu'il est nécessaire d'adopter rapidement le projet de loi et qu'il faudra peut-être modifier de nouveau la loi.

[*Français*]

**M. Blackburn :** C'est toujours une possibilité, effectivement, que vous, les membres du Sénat, en arriviez, en faisant l'analyse du projet de loi, à exprimer des points de vue ou certains amendements. Cela relève de votre prérogative et on le comprend fort bien.

Ceci m'amène, monsieur le président, à vous préciser que ce projet de loi apporte des changements nécessaires afin de corriger certaines lacunes techniques qui ont été cernées dans un projet de loi antérieur adopté par la Chambre des communes.

Le projet de loi antérieur, le projet de loi C-55, maintenant connu sous le nom de chapitre 47 des Lois du Canada 2005, a été introduit pour la première fois en juin 2005. Son objectif était de moderniser la Loi sur la faillite et l'insolvabilité et la Loi sur les arrangements avec les créanciers des compagnies, ainsi que de créer un cadre législatif pour le Programme de protection des salariés.

Les députés de tous les partis saisissent bien l'objectif du chapitre 47 : apporter des modifications nécessaires en matière d'insolvabilité et introduire des mesures permettant de protéger les travailleurs lorsque leur employeur fait faillite et qu'il n'a pas suffisamment d'actifs pour répondre aux réclamations légitimes de ses employés qui souhaitent récupérer leur indemnité et leurs salaires.

Je pense que tout le monde convient qu'il n'y a rien de plus logique, que de protéger les employés de l'entreprise en premier, en cas de faillite; c'est leur unique gagne-pain, c'est le gagne-pain de la famille, cela leur appartient, ils doivent au premier chef être ceux qui sont protégés.

Le chapitre 47 a été adopté rapidement par les deux Chambres du Parlement et a reçu la sanction royale en novembre 2005. Les partis ont convenu d'adopter la loi le plus rapidement possible en sachant fort bien qu'une législation aussi complexe nécessiterait d'autres révisions pour s'assurer qu'elle atteigne ses principaux objectifs sans conséquence imprévue.

Le projet de loi qui est devant nous représente une autre étape de cette révision, une révision qui comprenait un processus de consultations avec les intervenants et qui a mené à la recommandation de nombreux changements pour améliorer la législation initiale. Le nouveau projet de loi C-12 prévoit de nombreuses améliorations au chapitre 47. Entre autres, il remédie aux lacunes techniques qui surviennent souvent lorsqu'une loi crée un précédent, lacunes qu'il est essentiel de corriger.

J'aimerais souligner pourquoi le volet du nouveau projet de loi sur le Programme de protection des salariés est important et pourquoi nous espérons que les sénateurs pourront l'appuyer. Le Programme de protection des salariés est important, car il aborde

when an employer becomes bankrupt and there are not enough assets available to meet the legitimate claims of employees for unpaid wages and earned vacation pay.

In situations like these, through no fault of their own, workers can be left without the income to which they are legally entitled, simply because there is not enough money available to pay them. Bankruptcy data show that this is most often a problem in the case of small businesses. Some 70 per cent of corporate bankruptcies are in businesses with less than 10 employees. Sectors such as retail, food services and accommodation are prominent among them.

If a business goes bankrupt, its employees are legally entitled to receive their back wages and earned vacation pay, but the capacity to meet their claims depends on the value of the assets available in the bankrupt employer's estate. In other words, if the employer does not have enough money, in most cases, the employees are the ones who end up with nothing.

Too often those assets are not sufficient to cover the legitimate claims of the employees. The data tell us that after a bankruptcy, the average worker receives only 13 cents on the dollar, in total, and only after lengthy delays. Bankruptcies and receiverships can take up to three years to resolve. Worse still, in bankruptcies, about 75 per cent of workers receive nothing when their employer goes bankrupt.

A typical individual claim is not large — almost always less than $3,000 in claims for wages. But although the amounts are not large, not receiving them can be devastating to someone who has just lost his or her job and needs the money right away.

As senators and legislators, we can do something about this. For example, senators can support Canadian workers and their families. You can protect employees whose wages may be at risk in the event of a bankruptcy by supporting the important technical amendments that are set out in Bill C-12. This will enable the Wage Earner Protection Program to be brought into force as quickly as possible.

The Wage Earner Protection Program has a single priority: to protect workers because they are the most vulnerable parties in a bankruptcy. The WEPP will protect workers' unpaid wages and earned but unused vacation pay, up to an amount equalling four weeks' maximum insurable earnings under the Employment Insurance Act, or approximately $3,000 at this time.

The government estimates this will satisfy in full some 97 per cent of the typical claims that would arise on the part of workers affected by bankruptcies. The program will ensure that workers get their wages quickly. This is vitally important because it comes at a time when they really do need the money. When a

les problèmes qui peuvent survenir lorsqu'un employeur fait faillite et qu'il n'a pas suffisamment d'actifs pour répondre aux réclamations légitimes de ses employés qui souhaitent récupérer leur indemnité et leur salaire.

Dans de telles situations et sans que ce soit leur faute, les travailleurs se retrouvent sans le salaire auquel ils ont droit, car il n'y a pas suffisamment d'argent pour les payer. Les données sur les faillites révèlent que cela peut représenter un problème véritable, surtout dans le cas des PME. Près de 70 p. 100 des faillites touchent des entreprises de moins de dix employés, principalement dans les secteurs du commerce de détail, des services alimentaires et de l'hébergement.

Si une entreprise fait faillite, les employés ont le droit de recevoir les salaires et les indemnités impayées, mais la capacité des répondre à ces réclamations dépend de la valeur des actifs de l'employeur en faillite. Autrement dit, si l'employeur n'a pas suffisamment d'argent, ce sont les employés qui, dans la plupart des situations, se retrouvent avec rien.

Trop souvent, ces actifs ne sont pas suffisants pour couvrir les réclamations légitimes des employés. Les données révèlent qu'après une faillite, le travailleur moyen ne reçoit au total que 13 cents du dollar qui lui est dû, et ce, après de longs délais de processus de faillite. Les faillites et les séquestres peuvent parfois prendre jusqu'à trois ans avant de se régler. Pire encore, on dit qu'environ 75 p. 100 des travailleurs ne reçoivent absolument rien lorsque leur employeur fait faillite.

On estime que la réclamation individuelle type est, règle générale, peu élevée. On dit que les réclamations de ceux qui veulent obtenir leur salaire sont quasiment toujours inférieures à 3 000 $. Même si les montants sont peu élevés, le fait de ne pas pouvoir les récupérer peut être dévastateur pour un employé qui vient de perdre son emploi et qui a besoin de son argent rapidement.

En tant que sénateurs et législateurs, nous pouvons faire quelque chose. Entre autres, les membres du Sénat peuvent aider les travailleurs canadiens et leur famille et protéger les employés dont les salaires sont menacés lors d'une faillite, et ce, en appuyant les modifications techniques mises de l'avant dans le projet de loi C-12, lequel permet de mettre en place le Programme de protection des salariés le plus rapidement possible.

Le Programme de protection des salariés s'articule autour d'une seule priorité. Il vise à protéger les travailleurs qui constituent le groupe le plus vulnérable dans le cas d'une faillite. Le programme protégera les salaires et les indemnités de congé annuel non payé des travailleurs jusqu'à concurrence d'un montant correspondant à quatre semaines de salaire et au maximum de la rémunération assurable selon la Loi sur l'assurance emploi, ce qui correspond actuellement à 3 000 $, somme qui sera bien sûr indexée au fil des années.

Le gouvernement estime que cela permettra de répondre à près de 97 p. 100 des réclamations qui sont déposées par les travailleurs touchés par une faillite. Le programme permet de s'assurer que les travailleurs touchent leur salaire rapidement, à un moment où ils ont le plus besoin d'argent. On sait que lorsque

company goes bankrupt, workers have to find a job elsewhere, and this results in consequences in their life. In addition to losing their wages, they find themselves with no prospects.

Meeting the legitimate claims of workers for unpaid wages or earned vacation pay will no longer depend on how much is in an employer's estate.

The Wage Earner Protection Program is a good idea. All parties supported the concept when chapter 47 was passed. And all should support the technical amendments in Bill C-12, because they are the changes senators wanted to make and they reflect past decisions.

This program has also been welcomed by key stakeholders in the insolvency and labour communities. The Canadian Association of Insolvency and Restructuring Professionals has written to the government expressing its support for the WEPP.

The Insolvency Institute of Canada also expressed support for the WEPP in a submission made to the standing committee along with some technical suggestions. And the National Bankruptcy and Insolvency Section of the Canadian Bar Association has publicly expressed its support for the WEPP.

In the labour community, major groups such as the United Steel Workers of America and the Canadian Labour Congress have also expressed their strong support for the WEPP.

In fact, the Canadian Labour Congress has been advocating for a program to protect employees' wages in the event of an employer's bankruptcy for some time. In other words, there is widespread support for the bill. But at the same time, there is also a shared recognition that the original legislation must be amended to achieve its original objectives without resulting in unintended consequences.

These amendments include the following. First, we proposed to amend the WEPP Act so that program payments reflect deductions which would have been applied to workers' wages had they been paid in the normal course.

WEPP payments will be reduced by an amount equalling an employee's EI and Quebec/Canada Pension Plan contribution. This is not a major provision at all, but it is logical.

Secondly, Bill C-12 proposes to enhance the fairness of the conditions of eligibility. The WEPP Act, as passed in chapter 47, made wage earners who were employed for three months or less ineligible for the program. we saw that this was a problem, and we wanted to correct it.

l'entreprise fait faillite, le travailleur doit trouver un emploi ailleurs et cela amène des conséquences dans sa vie. En plus de perdre son salaire, il se retrouve avec rien devant lui.

La capacité de répondre aux réclamations légitimes des travailleurs qui souhaitent récupérer leur salaire et leur paye de vacances ne dépendra donc plus des actifs de l'employeur.

Le Programme de protection des salariés est une bonne initiative. Tous les partis ont appuyé le concept lorsque le chapitre 47 a été adopté, et tous devraient appuyer les modifications techniques du projet de loi C-12 puisque les modifications techniques correspondent à ce que les sénateurs veulent apporter comme changements et qu'elles sont en lien avec les décisions antérieures.

Ce programme a été bien accueilli par tous les intervenants du milieu de l'insolvabilité et des organisations syndicales. Précisons que l'Association canadienne des professionnels de l'insolvabilité et de la réorganisation a exprimé son soutien au gouvernement à l'égard de ce programme.

L'Institut d'insolvabilité du Canada a également exprimé son soutien pour le programme dans une présentation faite au comité permanent et lui a présenté quelques suggestions d'ordre technique. De plus, la Section nationale de la faillite et de l'insolvabilité de l'Association du Barreau canadien a exprimé publiquement son soutien pour le Programme de protection pour les salariés.

Dans le milieu des organisations syndicales, d'importants groupes tels les Métallurgistes unis d'Amérique, le Congrès du travail du Canada, ont également déclaré être très favorables au présent projet de loi.

En fait, le Congrès du Canada préconisait depuis un certain temps la mise en place d'un programme de protection des salariés en cas de faillite de l'employeur. En d'autres termes, les partis sont largement favorables à cette loi. On s'accorde toutefois à reconnaître que la mesure législative initiale doit être modifiée afin qu'elle puisse atteindre ses objectifs initiaux sans qu'il y ait de conséquences imprévues.

Voici les modifications clés dont il est question. Premièrement, il est proposé de modifier la Loi de la protection pour les salariés afin que les prestations versées dans le cadre du Programme de protection des salariés reflètent les retenues qui auraient été faites sur le salaire des travailleurs s'ils avaient été payés de la façon habituelle.

On déduira des indemnités du Programme de protection des salariés un montant qui correspond aux cotisations d'un employé à l'assurance emploi ainsi qu'au Régime de rente du Québec ou au Régime de pensions du Canada. En somme, il n'y a rien de majeur dans cette disposition, mais il y a une logique à tout cela.

Deuxièmement, le projet de loi C-12 propose de rendre les conditions d'admissibilité plus justes. Selon la LPPS, telle qu'elle a été adoptée au chapitre 47, les salariés comptant trois mois d'emploi sont admissibles au Programme de protection des salariés. Voyant qu'il y avait une lacune dans cette mesure, on a voulu la corriger.

This measure was intended to prevent abuse of the WEPP by employers who may hire workers in the period immediately preceding the bankruptcy or receivership without intending to pay them.

However, it is recognized that this measure may unfairly penalize workers who have accepted a position with the employer in good faith in the period leading up to the bankruptcy or receivership. It is therefore proposed that this provision be replaced with a new eligibility requirement that individuals who are not dealing at arm's length with key decision-makers in the business are ineligible.

However those relatives who are excluded will have the opportunity to establish their eligibility. Thirdly, the bill explicitly proposes to allow trustees, receivers and other persons with a defence of due diligence when they have proven that they have done everything in their power to fulfil their duties under the act.

In certain cases, there maybe insufficient assets to pay trustees and receivers. In such situations, insolvency professionals may decline to take on the case, which would prevent those wage earners from accessing the WEPP.

Therefore, an amendment is proposed that would allow the WEPP to pay insolvency professionals, in certain cases and under certain conditions, for carrying out duties related to the operation of the WEPP.

It is proposed that the WEPP act be amended to require people who have tabled information, or who have access to payroll information, to assist trustees and receivers in performing their duties under the act. Furthermore, the WEPP act would also make it an offence to fail to comply with this duty.

I would also like to take this opportunity to say a few words about the need to make some amendments through this bill to ensure student borrowers are treated fairly when falling into bankruptcy. The federal and provincial student loan programs assist many needy students each year but their continued ability to do so is tied to timely repayment by recipients.

Prior to 1998, many student borrowers were declaring bankruptcy. The losses to government due to these bankruptcies were large and growing quickly — I believe that the amount was about $100 million at the time. As a result, the bankruptcy and insolvency act was amended in 1998 to prevent the discharge of these debts for 10 years following completion of post-secondary studies.

L'objet de cette mesure était d'éviter le recours abusif au programme par les employeurs qui pourraient choisir d'embaucher des travailleurs au cours de la période précédant immédiatement leur faillite ou la mise sous séquestre avec l'intention de ne pas les payer.

Toutefois, on reconnaît que cette mesure pourrait pénaliser injustement des travailleurs qui ont accepté de bonne foi un poste chez un employeur au cours de la période en question. Par conséquent, il est proposé que cette disposition soit remplacée par un nouveau critère selon lequel les personnes qui ne sont pas indépendantes des principaux décideurs d'une entreprise seraient inadmissibles à l'aide du programme.

Cependant, les personnes qui ont un lien de parenté et qui sont exclues auront toujours la possibilité de prouver leur admissibilité. Troisièmement, le projet de loi propose explicitement d'accorder aux syndics, aux séquestres et aux autres personnes le droit à une défense de diligence raisonnable lorsqu'ils prouvent qu'ils ont déployé tous les efforts possibles pour s'acquitter de leurs obligations en vertu de la loi.

Dans certains cas, l'actif de l'employeur peut être insuffisant pour payer les syndics et les séquestres et on a aussi voulu corriger cela. Dans de tels cas, les professionnels de l'insolvabilité peuvent refuser de se charger du dossier, ce qui empêcherait les salariés d'obtenir l'aide du Programme de protection des salariés.

On propose donc d'apporter une modification à la loi qui permettrait de payer les professionnels de l'insolvabilité dans le cadre du Programme de protection des salariés, et ce, dans certains cas et à certaines conditions, pour qu'ils exécutent les tâches liées au fonctionnement du programme.

Il est proposé de modifier la loi afin d'obliger toute personne qui détient des renseignements sur les salaires ou qui a accès à de tels renseignements à aider les syndics et les séquestres à s'acquitter des obligations qui leur incombent selon la loi. De plus, la loi pourrait contenir des dispositions indiquant que le défaut de s'acquitter de cette obligation constitue une infraction à la loi.

Je voudrais également saisir cette occasion pour glisser un mot sur la nécessité d'apporter des modifications par le truchement de ce projet de loi pour que les étudiants emprunteurs qui tombent en faillite soient traités de façon équitable. Pour que les programmes de prêts des gouvernements fédéral et provinciaux puissent continuer d'aider chaque année les étudiants qui en ont besoin, les bénéficiaires doivent rembourser leurs prêts à temps.

Avant 1998, bon nombre d'étudiants emprunteurs déclaraient tout simplement faillite pour ne pas avoir à payer leur prêt. Après ces faillites, le gouvernement subissait des pertes considérables — je pense qu'à ce moment-là on parlait même de montants autour de 100 millions de dollars. C'était assez important et ces coûts augmentaient rapidement. Par conséquent, la loi sur la faillite et l'insolvabilité a été modifiée en 1998, pour que les étudiants ne puissent pas être libérés de ces dettes pendant une période de dix ans après la fin de leurs études postsecondaires.

Chapter 47 will reduce the discharge prohibition period from ten to seven years and, in the case of hardship, five years. These new time periods align with the debt repayment assistance measures available under the Canada Student Loans Program and its many provincial equivalents. This represents a significant improvement for the plight of student loan debtors and encourages them to take advantage of the debt management measures available with the student loan regimes before considering bankruptcy and its longer term financial impacts.

It was always been the intention that the new waiting periods in chapter 47 would apply immediately, however, due to a wording error, chapter 47 would not help those already bankrupt. We want to ensure that those who are already bankrupt are covered.

This new bill would fix that problem by making sure that the seven-year period would apply to individuals who had already filed for bankruptcy but had not yet been discharged. In addition, the five-year waiting period for those who can show hardship will apply to all bankrupts, past, present and future. This will bring immediate relief for student loan debtors who are currently in need of assistance.

To conclude, I am proud to support this new bill. When two departments are involved in introducing legislation, it is always complicated. This bill was a joint responsibility between us, at the Department of Labour, and Industry Canada. Each one waits for the other to act, and both have changes to bring forward. Everyone is acting in good faith, but when two departments are involved, things are more complicated and everything takes longer. That is why I am proud today; we have had to start over twice and get unanimous consent twice in the House of Commons to bring this bill to the Senate, as you had initially requested. That is why I am proud to support this new bill.

It is now in your hands for final consideration. With your support, Canadian workers can finally be protected in the event of an employer's bankruptcy.

[*English*]

**The Chair:** Thank you very much, Mr. Minister. Ladies and gentlemen, I think you would all agree that that was an eloquent portrayal of the government's position with respect to the WEPP, or the wage earner protection elements of the bill, but it is a very large bill. I think in terms of verbiage and language in the bill, Minister Blackburn, your portion, the PPP part, is probably less than half of the bill, right, in terms of this bill but equally important.

Just to put it all in perspective and you have made your comments now, our practice usually is to have both the witnesses and the ministers, give their presentations and then we will go to

Le chapitre 47 des Lois du Canada 2005 permettra de réduire la période d'interdiction de libération de dix à sept ans. Si quelqu'un a des difficultés majeures, on peut même aller jusqu'à cinq ans. Ces nouvelles périodes correspondent aux mesures d'aide au remboursement des dettes qui sont offertes dans le cadre du programme canadien de prêts aux étudiants et de ses nombreux équivalents provinciaux. Il s'agit en somme d'une amélioration importante du sort des débiteurs étudiants dont la situation est critique. Elle les encourage à profiter des mesures de gestion de la dette offerte par les régimes de prêts aux étudiants avant d'envisager une faillite et ses répercussions à plus long terme.

L'intention du chapitre 47 a toujours été de faire en sorte que les nouvelles périodes d'attente prévues au chapitre 47 s'appliquent immédiatement. Cependant, en raison d'une erreur de libellé, le chapitre 47 n'aiderait pas ceux qui sont déjà en faillite. On veut faire en sorte que même ceux qui le sont puissent être couverts.

Le nouveau projet de loi corrigerait le problème en garantissant que la période de sept ans s'appliquerait aux personnes qui ont déjà déclaré faillite, mais qui n'ont pas encore été libérées. En outre, la période d'attente de cinq ans, pour ceux qui peuvent faire la démonstration de leurs difficultés, s'appliquera à tous les faillis passés, présents et futur. Ainsi, de nombreux débiteurs de prêts étudiants qui sont dans le besoin bénéficieront d'une libération immédiate.

Pour conclure, je suis fier d'appuyer ce nouveau projet de loi. Quand deux ministères sont impliqués pour déposer un projet de loi, c'est toujours compliqué. Cela relevait de nous, le ministère du Travail, et de celui de l'Industrie. Chacun attend après l'autre et chacun a des correctifs à apporter. Tout le monde est de bonne foi, mais quand deux ministères sont impliqués, c'est plus compliqué et cela prend plus de temps. C'est pour cela que je suis fier aujourd'hui, cela fait deux fois qu'on recommence, cela fait deux fois qu'on obtient l'unanimité à la Chambre des communes pour porter ce projet de loi devant le Sénat, tel que vous le souhaitiez, d'ailleurs, à l'origine. C'est pour cela que je suis fier d'appuyer ce nouveau projet de loi.

Il est maintenant entre vos mains pour cette dernière analyse. Avec votre appui, enfin, les travailleurs canadiens pourraient être protégés de la faillite de leur employeur.

[*Traduction*]

**Le président :** Je vous remercie beaucoup, monsieur le ministre. Mesdames et messieurs, je pense que vous conviendrez avec moi que le ministre nous a très bien exposé la position du gouvernement à l'égard du PPS, soit le Programme de protection des salariés. Il est cependant vrai qu'il s'agit d'un imposant projet de loi. La partie du projet de loi qui vous concerne, monsieur le ministre Blackburn, le PPS, représente sans doute moins de la moitié du projet de loi, mais c'est tout de même une partie importante de celui-ci.

Dans le but de replacer les choses dans leur contexte — et vous avez maintenant terminé votre exposé —, nous avons pour habitude de demander aux deux témoins et aux ministres de faire

the questioning. However, I believe I am right that Senator Goldstein needs to leave in a minute and he might want to question the minister.

**Senator Goldstein:** Thank you. I have been trying very hard to wait until the end of each hearing for my questions to give the other members of the committee a chance to do so, but exceptionally today, because I have to be elsewhere at a major event with respect to Darfur, I have informed the chair that I will have to leave shortly.

First, let me congratulate you and thank you for bringing the amending statute forth and for making the efforts, which you did make successfully to have the bill referred to the Senate and from the Senate to this committee as quickly as possible.

I want to address for just a moment the very last part of your excellent observations, Mr. Minister, and I want to deal with the issue of student loans.

The position which many of us take, and which I have clearly taken with respect to a private member's bill that is presently before the Senate, is that the student loan program is a program, not a business. It is not meant or intended to be profitable. It is meant and intended to aid students, and if students who find themselves with an impossible burden of debt and find themselves unable to repay that debt, then the program has to accommodate those needs.

I say that because you indicated in your remarks that the reason the law was amended in 1998 was to force — I use the term advisedly — students to wait 10 years before they can rid themselves of the burden of their student debts was an amendment which you say resulted from what appeared to be a plague of student bankruptcies who would graduate and then virtually immediately go into bankruptcy.

Without going into whether those statistics are accurate or not, because I have different statistics, it seems to me that the discharge process enables the courts to stop those abuses and to stop students from going into bankruptcy for the mere sport of doing so or go into bankruptcy because it is a simple way to start afresh.

That process remains intact, and that, with respect, is the process that should be used to discourage student strategic bankruptcies. This committee suggested in its 2003 report that the 10-year period be reduced to five years. The bill proposes seven years. The amount of time is not as important as the ability of the courts to be able to relieve legitimately impossible or difficult situations.

You have recognized that by providing a five-year window so that after five years a student can apply to the court in matters of financial difficulty and be relieved of the burden of his or her debts, in whole or in part. I would suggest to you that it would be appropriate for that five-year limitation to disappear and for students to be able to go to court at any point in time to be able to be relieved of their debts, if it is legitimate for them to do so.

leurs exposés avant d'ouvrir la période des questions. Comme le sénateur Goldstein doit cependant nous quitter dans quelques instants, je crois qu'il aimerait d'abord poser une question au ministre.

**Le sénateur Goldstein :** Je vous remercie. J'ai essayé très fort d'attendre à la fin de chaque témoignage pour poser mes questions, mais je dois exceptionnellement aujourd'hui poser mes questions tout de suite car je devrai partir très bientôt pour participer à un important événement se rapportant à la situation au Darfour.

Permettez-moi d'abord de vous féliciter d'avoir proposé ces amendements à la loi et d'être parvenu à renvoyer aussi rapidement le projet de loi devant le Sénat et, par la suite, devant notre comité.

Si vous me le permettez, monsieur le ministre, j'aimerais traiter de la dernière partie de votre excellent exposé, laquelle porte sur les prêts étudiants.

La position que bon nombre d'entre nous défendent — et que j'ai moi-même défendue à l'égard d'un projet de loi d'initiative parlementaire dont le Sénat est actuellement saisi —, c'est que le Programme de prêts aux étudiants est justement un programme et non pas une entreprise. Son objectif n'est pas de faire des profits. Le programme vise à aider les étudiants, et notamment les étudiants qui ne sont pas en mesure de rembourser leurs dettes.

Si je fais cette observation, c'est que vous avez dit dans votre allocution que la raison pour laquelle la loi avait été modifiée en 1998, c'était pour forcer — j'utilise ce terme en connaissance de cause — les étudiants à attendre dix ans avant de pouvoir demander que leur dette soit radiée. Cet amendement s'était révélé nécessaire en raison du grand nombre d'étudiants qui déclaraient faillite presque immédiatement après avoir terminé leurs études.

Je ne me lancerai pas dans une querelle de statistiques parce que les statistiques que j'ai brossent un tableau différent de la situation, mais j'ai l'impression que les tribunaux sont en mesure d'empêcher ce genre d'abus et notamment d'empêcher les étudiants de déclarer faillite pour le simple plaisir de repartir à zéro.

Ce processus demeure inchangé et c'est le processus auquel on devrait recourir pour dissuader les étudiants de déclarer faillite pour des raisons stratégiques. Dans son rapport publié en 2003, le comité a recommandé que la période de dix ans soit ramenée à cinq ans. Le projet de loi propose que cette période soit de sept ans. La période choisie est en elle-même moins importante que la capacité des tribunaux d'aider les étudiants qui, pour des raisons légitimes, se trouvent dans une situation difficile, voire impossible.

Vous avez tenu compte de la situation en proposant qu'un étudiant puisse demander à un tribunal de radier en partie ou en entier sa dette s'il connaît des difficultés financières. Je suis d'avis que l'exigence de cinq ans devrait être éliminée et qu'on devrait pouvoir permettre aux étudiants de demander la radiation de leurs dettes s'il est légitime qu'ils le fassent.

I emphasize that part of it, "if it is legitimate for them to do so." We have faith in the courts and in their discretion, and we particularly and especially have faith in the judges who are actively involved in matters of bankruptcy and insolvency who are very experienced people who do not readily permit abuses and would not count on its abuses.

**The Chair:** Is there a question, senator? Really, you are sort of a little bit off point here.

**Senator Goldstein:** I know. There is about to be a question.

Would you consider eliminating the five-year limitation and substituting instead an ability on the part of the courts to make a determination at any time if there is severe and difficult hardship that a student is encountering?

[*Translation*]

**Mr. Blackburn:** Mr. Deputy Chair, as you know, this bill has gone through a number of hands and has been analyzed a number of times. It is true that in 1995-96, the government said that students would have to wait two years before filing for bankruptcy in order to be discharged. They realized that this provision had no effect. The government of the day amended its legislation to increase the discharge prohibition period.

According to the statistics, 10,798 students declared bankruptcy in 1995-96, which cost the government $100 million. In 2004-2005, there were only 3,987. That is less than half as many as before. In the new legislation, the prohibition period is reduced from ten years to seven. We feel that that period will be appropriate.

If a student wants to go to court and argue that five years would not be enough, the judge can always rule that the period should be set at five years.

You are proposing that judges ultimately make the decision. I cannot say that that is an unreasonable argument; in fact, it does have merit. Can we not try out the current provisions and make other changes later if necessary? Perhaps the officials from Human Resources and Social Development Canada have comments on that question.

[*English*]

**Rosaline Frith, Director General, Canada Student Loans Program, Human Resources and Social Development Canada:** The program is currently designed to ensure that someone who would fall into bankruptcy is given as much assistance in terms of debt management as is possible. Therefore, any student that has difficulty repaying his or her loan at the end once they have consolidated, and anytime thereafter for the first five years after leaving school, can apply for interest relief; so can someone who falls into bankruptcy.

During that interest relief period, they do not have to make any payments on their Canada Student Loan, and the government covers the interest cost associated with that loan. If there is any

J'insiste sur le fait que cette demande doit être légitime. Nous faisons confiance aux tribunaux ainsi qu'à la façon dont ils exercent leur pouvoir discrétionnaire et en particulier, nous faisons confiance aux juges qui se prononcent dans les questions de faillite et d'insolvabilité puisqu'il s'agit de personnes expérimentées qui ne sont pas prêtes à accepter qu'on abuse du programme.

**Le président :** Avez-vous une question à poser, sénateur? Je crois que vous vous écartez un peu du sujet.

**Le sénateur Goldstein :** Je sais. Je suis sur le point de poser ma question.

Êtes-vous prêt à envisager l'élimination de l'exigence de cinq ans et de permettre plutôt aux tribunaux d'établir si la situation financière d'un étudiant justifie qu'il demande la radiation de sa dette?

[*Français*]

**M. Blackburn :** Monsieur le vice-président, vous savez, ce projet de loi est passé entre plusieurs mains et a été analysé à plusieurs reprises. Effectivement, au début, en 1995-1996, le gouvernement avait dit que les étudiants devraient attendre deux ans avant de pouvoir faire faillite pour pouvoir être libéré. Ils se sont aperçus que cela n'avait pas d'effet. Le gouvernement à l'époque a modifié sa loi pour augmenter le nombre d'années.

Les statistiques révèlent qu'en 1995-1996, 10 798 étudiants avaient déclaré faillite, cela coûtait 100 millions de dollars au gouvernement. En 2004-2005, le nombre est passé à 3 987. C'est une diminution de plus de la moitié. Dans la nouvelle loi, on dit que la période va le passer de dix à sept ans. On pense que la mesure peut être valable.

Si un étudiant veut aller devant la cour, qu'il estime que pour lui cinq ans seraient insuffisants, le juge peut toujours prendre la décision de ramener le tout sur cinq ans.

Vous proposez que le juge prenne ultimement une décision. Je ne peux pas vous dire que c'est un point de vue déraisonnable. Il a de la valeur aussi. Ne peut-on pas essayer ce que l'on a actuellement et, ultimement, apporter d'autres correctifs ultérieurement? Peut-être que les gens du ministère Ressources humaines et Développement social Canada ont des commentaires à formuler sur cette question.

[*Traduction*]

**Rosaline Frith, directrice générale, Programme canadien de prêts aux étudiants, Ressources humaines et Développement social Canada :** Le programme est actuellement conçu de manière à aider, le plus possible, une personne susceptible de faire faillite à gérer sa dette. Par conséquent, un étudiant qui a du mal à rembourser son prêt peut, après avoir consolidé ses dettes, et à tout moment, dans les cinq ans suivant la fin de ses études, demander une exemption d'intérêts. Un étudiant qui fait faillite peut demander la même chose.

Pendant la période d'exemption d'intérêts, l'étudiant n'a pas à rembourser son prêt étudiant et c'est le gouvernement qui paie les intérêts sur le prêt. Si l'étudiant a toujours du mal à rembourser sa

difficulty at the end of that five-year period, they can go into debt reduction in repayment and an additional $26,000 can be reduced from their overall loan. For most students, that would mean they have no loan at the end.

Right now, the average student loans, including the provincial loans, are less than $20,000. Therefore, in effect, the design of the program is such that if students were suffering from hardship, there are programs available to help them through that period so that they do not have to make any payments. That essentially reduces any burden on the courts to have to deal with those cases.

At the five-year period, according to Bill C-12, with the amendments, a person would be entitled to immediately seek to have their bankruptcy discharged. We believe they are fully covered under the current program with Bill C-12.

**Senator Goldstein:** Have you dealt with the study done by Professor Stephanie Ben-Ishai with respect to the Canada Student Loan Program? Also, have you dealt with any of the literature submitted by a variety of student organizations?

I raise the question because they, with respect, dispute the figures and the ability of students to access the programs. For example, if a student is in default because of financial difficulty — and you define default as three months of non-payment — then the student is not admissible to any of those programs.

**Ms. Frith:** Default is defined as 270 days in arrears, which is nine months. Every action is taken to deal with those students during that period to try and get them back into good standing. If there is a legitimate reason why they are having difficulty repaying their loan during that period, then the service provider — or even Canada Revenue Agency, should they already be in collections — will try to work out a repayment program that is reasonable and affordable.

I have dealt with many of the issues that come up around bankruptcy. The current program and policies deal effectively with bankruptcies and try to take into account any difficulties students may be having in repaying their loans. If they go bankrupt while studying full-time they are even still be eligible to receive student loans for an additional three years so they can graduate. The program today is effective — but I say "today." There are cases from the past that are still experiencing difficulties.

**Senator Goldstein:** If the student is unemployed for nine months and cannot make a payment, what kind of relief is available to that student? There is none.

**Ms. Frith:** If they were unemployed during that nine months, they would have gone on to interest relief, which means they did not have to pay any interest — the government paid the interest and they would not have to make any payment on the principal

dette à la fin de la période de cinq ans, une somme supplémentaire de 26 000 $ peut être défalquée de la dette totale. Pour la plupart des étudiants, cela signifie qu'ils n'ont plus de dette.

À l'heure actuelle, les prêts étudiants moyens, ce qui comprend les prêts provinciaux, s'élèvent à moins de 20 000 $. Le programme est donc ainsi conçu que les étudiants qui connaissent des difficultés financières n'ont pas à rembourser leur dette pendant cinq ans. Il ne devient donc plus nécessaire aux tribunaux de se pencher sur ce genre de cas.

À la fin de la période de cinq ans, d'après les modifications proposées dans le projet de loi C-12, une personne pourrait immédiatement demander à ce que sa dette soit radiée. Nous croyons que le projet de loi C-12 et que le programme actuel règlent complètement ce problème.

**Le sénateur Goldstein :** Avez-vous pris connaissance de l'étude réalisée par le professeur Stephanie Ben-Ishai en ce qui concerne le Programme canadien de prêts aux étudiants? Avez-vous par ailleurs pris connaissance des observations écrites des diverses organisations qui représentent les étudiants?

Je pose la question parce que, sauf votre respect, ils contestent les chiffres et la prétendue capacité des étudiants d'avoir accès aux programmes. Par exemple, si un étudiant est en défaut de paiement en raison de difficultés financières — et vous définissez le défaut de paiement comme une période de trois mois sans versement — alors l'étudiant n'est admissible à aucun de ces programmes.

**Mme Frith :** Le défaut de paiement est défini comme une période de 270 jours de paiement en souffrance, soit neuf mois. Nous faisons tout ce que nous pouvons pour aider les étudiants à régulariser leur situation pendant cette période. S'ils ont du mal à rembourser leur prêt pour une raison légitime, alors le fournisseur de services — ou même l'Agence du revenu du Canada, s'ils sont déjà en recouvrement — essaiera de mettre sur pied un programme de remboursement raisonnable et abordable.

J'ai eu connaissance de la plupart des problèmes qui se posent lors d'une faillite. Le programme et les politiques actuels sont efficaces en cas de faillite et tiennent compte des difficultés que les étudiants sont susceptibles d'avoir lorsqu'ils ont à rembourser leur prêt. S'ils déclarent faillite pendant qu'ils sont aux études à plein temps, ils peuvent néanmoins être admissibles à des prêts pour trois années supplémentaires afin qu'ils puissent obtenir leur diplôme. Le programme en vigueur aujourd'hui est efficace — mais je dis bien « aujourd'hui ». Certains cas plus anciens continuent de donner lieu à des difficultés.

**Le sénateur Goldstein :** Si l'étudiant est en chômage pendant neuf mois et ne peut pas effectuer une mensualité, quel genre d'aide financière est disponible pour cet étudiant? Il n'y en a pas.

**Mme Frith :** Si un étudiant est en chômage pendant neuf mois, il peut se prévaloir du programme de remise des intérêts, ce qui signifie qu'il n'a pas à payer d'intérêts, qui est pris en charge par le gouvernement, et il n'a pas à faire de paiement sur le principal

during that period. They can do that up to 60 months without moving into default. They will be kept on interest relief for that whole period of time.

After five years, if they are still suffering a low level of income or unemployment, they can qualify for debt reduction in repayment, which would carry them over for a further two years, more likely three. By that time, under this new bill, they would be able to apply for their bankruptcy to be discharged.

**The Chair:** Thank you. We will be reporting to Minister Solberg about what a good job you did in handling those difficult questions.

Minister Blackburn, normally we would go on to the parliamentary secretary, but since your part of your bill is fairly focused, I would like to have all senators have their chance to question you.

**Senator Meighen:** I thought we would hear from both witnesses, but I understand why we have to deviate. The minister's time is at a premium.

[*Translation*]

Welcome to the Standing Senate Committee on Banking, Trade and Commerce, Mr. Blackburn. We have known each other for quite some time, and I congratulate you on this initiative. Everyone needs to be aware that no legislation is perfect. Perfection may be the aim, but there will always be flaws that creep in. During our hearings, you will hear suggestions directly or indirectly for improvements.

That said, I feel that the changes proposed by your department as well as by Human Resources and Social Development Canada incorporate the vast majority of the improvements sought by representatives from all the political parties. The problem, if there is one, is as follows, and it is rather technical.

[*English*]

I am happy to move ahead with the changes you have proposed because I think they are of critical importance. However, on a technical level — and I do not know who is best to answer this — if I look at clause 112 of the bill, there are specific references to certain clauses in Bill C-52 that do not match. For example, there is reference to section 94(1) of Bill C-52, which has no meaning because there was no such subsection in the final version of the bill. I understand that is just a drafting error, if I am correct. I can give you more specifics, if you like.

What I really want to know, minister — perhaps this is better addressed to Mr. Carrie — can the bill be proclaimed into force with those technical mistakes or must we have a technical amendment in order for the bill to come into force? If that is the case, can we have some assurance we can have that very promptly?

pendant cette période. L'étudiant peut procéder ainsi pendant 60 mois sans être réputé être en défaut de paiement. L'étudiant bénéficie de la remise d'intérêts pendant toute la période.

Si après cinq ans, l'étudiant a toujours un faible revenu ou est en chômage, il peut être admissible à une réduction de la dette en cours de remboursement, ce qui pourrait l'aider pendant deux années de plus, voire trois. Rendu là, aux termes de ce nouveau projet de loi, il pourrait demander à être libéré de la faillite.

**Le président :** Merci. Nous ferons rapport au ministre Solberg de l'excellent travail que vous avez fait lorsqu'on vous a posé ces questions épineuses.

Monsieur Blackburn, normalement nous passerions au secrétaire parlementaire mais puisque que les dispositions du projet de loi qui vous concernent sont très ramassées, j'aimerais que tous les sénateurs aient la possibilité de vous interroger.

**Le sénateur Meighen :** Je croyais que nous entendrions les deux témoins mais je comprends pourquoi nous changeons de programme. Le temps du ministre est précieux.

[*Français*]

Bienvenue au Comité sénatorial permanent des banques et du commerce, monsieur Blackburn. Nous nous connaissons depuis un bon bout de temps, et je vous félicite de cette initiative. Tout le monde doit tenir compte du fait que nul projet de loi n'est parfait. Tout projet de loi vise la perfection, peut-être, mais il y a toujours au hasard du jeu des lacunes. Au cours de nos audiences, vous entendrez directement ou indirectement des suggestions visant à apporter des améliorations.

Cela dit, je trouve que les changements proposés par votre ministère ainsi que le ministère des Ressources humaines et Développement social Canada répondent à la grande majorité des changements revendiqués par les représentants de tous les partis politiques. Le problème, s'il y en a un, est le suivant et il est plutôt technique.

[*Traduction*]

Je veux bien aller de l'avant avec les changements que vous avez proposés parce que nous constatons qu'ils revêtent une importance critique. Toutefois, au plan technique — et ne je sais pas qui pourra le mieux répondre à cette question — si nous examinons l'article 112 du projet de loi, il y a des renvois précis à certaines dispositions du projet de loi C-52 qui ne concordent pas. Par exemple, il y a un renvoi au paragraphe 94(1) du projet de loi C-52, ce qui ne fait aucun sens puisqu'il n'y a pas de tel paragraphe dans la version finale du projet de loi. Je comprends que c'est une simple erreur d'écriture. Je peux vous donner d'autres précisions, si vous le souhaitez.

Ce que j'aimerais savoir, monsieur le ministre — et je devrais peut-être poser ma question à M. Carrie — c'est si le projet de loi peut être promulgué malgré ces erreurs d'ordre technique ou s'il faut un amendement pour que le projet de loi puisse l'être? S'il faut un amendement, pouvez-vous nous garantir que l'amendement nous sera fourni très rapidement?

**Colin Carrie, M.P., Parliamentary Secretary to the Minister of Industry:** Thank you for bringing that up and bringing it forward. This is something that people will question us on. I would like to defer for the specifics to the department because we have had discussions on this matter.

**The Chair:** I invite Mr. Dooley to respond.

[*Translation*]

Senator Michel Biron, from the beautiful province of Quebec, has also joined us.

[*English*]

**Matthew Dooley, Senior Project Leader, Corporate and Insolvency Law Policy and Internal Trade, Industry Canada:** Thank you for the question. Yes, the bill can be brought into force in its current form. Unfortunately, when its predecessor, Bill C-52, the Budget Implementation Act, was drafted, a change at the last minute that withdrew two clauses threw off the numbering in Bill C-12 by two. Thank you for pointing that out. We have looked at it and are comfortable with it because the budget implementation act is in force and the drafting of Bill C-12 simply refers to the requirement that the clause referred to is in force. Bringing Bill C-12 forward in its current form will allow the sections to come into force as intended. It is a technical flaw but not one that is fatal to the bill.

**The Chair:** It does not need a formal amendment by Parliament, which was the gist of your question, Senator Meighen. Is that correct? Mr. Dooley, you are saying that it is such a technical and non-substantive change that under the rules that apply, it can be done?

**Mr. Dooley:** Yes.

**The Chair:** That is reassuring to all of us.

**Senator Meighen:** If we were to pass this bill before us as it reads, my understanding is it could be proclaimed into law tomorrow.

**The Chair:** We often put comments or observations when we report a bill to the House. Perhaps we could refer to this change in the report of the committee. Certainly, if it can be done, it would accelerate the matter.

**Senator Meighen:** I believe that I heard such a change would not delay the process.

**The Chair:** That is right.

[*Translation*]

**Senator Meighen:** Minister, some people feel that, given the impact of insolvency legislation on the Canadian economy, it needs to be revised periodically to make sure that it is fair and

**Colin Carrie, député, secrétaire parlementaire du ministre de l'Industrie :** Merci de nous avoir signalé l'erreur. Nous serons interrogés là-dessus. J'aimerais laisser aux fonctionnaires du ministère le soin de répondre à cette question parce que nous leur en avons parlé.

**Le président :** J'invite M. Dooley à répondre.

[*Français*]

Le sénateur Michel Biron, de la belle province de Québec, est arrivé également.

[*Traduction*]

**Matthew Dooley, chef principal de projet, Politique du droit corporatif, de l'insolvabilité et du commerce intérieur, Industrie Canada :** Merci de votre question. Oui le projet de loi peut être promulgué tel quel. Malheureusement, quand le projet de loi C-52, Loi d'exécution du budget, a été rédigé, un changement a été apporté à la dernière minute et l'on a retiré deux articles, ce qui a décalé de deux les numéros des articles du projet de loi C-12. Merci de nous l'avoir signalé. Nous avons lu les dispositions et nous n'avons pas de crainte parce que la Loi d'exécution du budget est en vigueur et le libellé du projet de loi C-12 ne fait qu'un renvoi précisant que l'article en question doit être en vigueur. En allant de l'avant avec le projet de loi C-12 tel quel, nous permettons tout simplement que les articles entrent en vigueur comme prévu. Il s'agit d'une erreur d'ordre technique qui n'est pas fatale.

**Le président :** Il n'est pas nécessaire que le Parlement adopte un amendement en bonne et due forme, ce qui était le sens de votre question, sénateur Meighen. Est-ce bien cela? Monsieur Dooley, vous nous dites qu'il s'agit d'un changement technique et non d'un changement de fond et que le projet de loi peut être adopté tel quel?

**M. Dooley :** Oui.

**Le président :** Nous en sommes tous rassurés.

**Le sénateur Meighen :** Si nous devions adopter le projet de loi tel quel, je crois comprendre qu'il pourrait être promulgué demain.

**Le président :** Nous ajoutons souvent des commentaires ou des observations quand nous faisons rapport du projet de loi au Sénat. Le comité pourrait peut-être signaler cette erreur dans son rapport. Si c'était possible, cela accélérerait certainement les choses.

**Le sénateur Meighen :** Je crois qu'on nous a dit que le changement ne retarderait rien.

**Le président :** C'est exact.

[*Français*]

**Le sénateur Meighen :** Monsieur le ministre, certains estiment que, compte tenu de l'impact des lois sur l'insolvabilité sur l'économie canadienne, il faut périodiquement les refondre pour

effective and still in line with identified objectives. That being the case, is it desirable to have provisions in all Canadian insolvency legislation for a mandatory parliamentary review?

**Mr. Blackburn:** Perhaps my colleague Mr. Carrie could answer that, since it deals more with his department's responsibilities.

[*English*]

**Mr. Carrie:** As you propose, this proposed legislation would undergo review every five years. Because of its complexity, the review would be ongoing. I would ask Mr. Charland to comment on this.

[*Translation*]

**Roger Charland, Senior Director, Corporate and Insolvency Law Policy and Internal Trade, Industry Canada:** Thank you for the question. As Mr. Carrie mentioned, the bill contains a five-year review clause; in five years, the government must table a report in both Houses of Parliament on developments in the legislation and how it has been implemented. That is the review process set out in Bill C-12.

In legislation on matters such as bankruptcy and chapter 47, there is always ongoing monitoring by the government to see how the provisions and legislation are implemented over time and what impact they have had. Continuity is ensured, as well as the review or report five years on, as set out in Bill C-12.

**Senator Meighen:** It seems to me that this kind of monitoring takes place with all legislation. Is five years not a bit long?

**Mr. Charland:** The ongoing monitoring does apply to all legislation, but not all bills set out the obligation or a process for a report to be tabled in both the House and Senate in the fifth year of implementation. That is unusual. It is true from a perspective of policy development or ongoing monitoring, but not all bills contain this kind of clause. In this case, the legislation provides for a report to be tabled in five years in both Houses concerning the impact and developments with respect to Bill C-12.

[*English*]

**The Chair:** It would be a more in-depth five-year review as opposed to the ongoing housekeeping amendments.

I am concerned that we are moving away from labour and speaking more to industry. A strong side of me wants to have Mr. Carrie testify. Do you mind if we go to Mr. Carrie?

**Senator Harb:** Chair, if I may, I have to leave soon and I have questions for the minister.

veiller à ce qu'elles continuent d'être équitables et efficaces, et continuent de concrétiser les objectifs prévus. Cela étant, les dispositions de toutes les lois canadiennes sur l'insolvabilité ayant trait à l'examen parlementaire obligatoire sont-elles une caractéristique souhaitable?

**M. Blackburn :** Peut-être que mon collègue, M. Carrie, pourrait répondre, étant donné que cela concerne davantage son ministère.

[*Traduction*]

**M. Carrie :** Comme vous le proposez, le projet de loi pourrait être réexaminé tous les cinq ans. En raison de sa complexité, l'examen serait continu. J'aimerais entendre la réaction de M. Charland.

[*Français*]

**Roger Charland, directeur principal, Politique du droit corporatif, de l'insolvabilité et du commerce intérieur, Industrie Canada :** Merci de la question. Comme le précisait M. Carrie, le projet de loi prévoit une clause de révision aux cinq ans; dans cinq ans le gouvernement doit déposer un rapport auprès des deux Chambres du Parlement sur l'évolution de la loi et comment elle a été appliquée. C'est le processus de révision prévu par le projet de loi C-12.

Dans le cadre de lois comme les lois sur les faillites et le chapitre 47, il y a toujours un suivi continu par le gouvernement, de façon à voir comment, avec le temps, les dispositions et les législations s'appliquent, et les impacts qu'elles ont eus. Il y a une continuité qui s'installe, tout cela avec une révision ou un rapport déposé dans cinq ans, tel que le prévoit le projet de loi C-12.

**Le sénateur Meighen :** Il me semble que ce suivi s'applique à toutes les lois. Cinq ans, n'est-ce pas une période un peu longue?

**M. Charland :** Le suivi continu s'applique en effet dans tous les projets de loi, mais pas tous les projets de loi prévoient l'obligation ou un processus de dépôt de rapport devant les deux Chambres dans la cinquième année de l'application. Ce n'est pas usuel. C'est vrai d'un côté, dans une perspective de développement de la politique et un suivi continu, mais tous les projets de loi ne contiennent pas cette clause. Cela avait été fait, ici, pour que, dans cinq ans, il y ait cette occasion de revenir avec un rapport devant les deux Chambres et faire une étude sur l'impact et le développement qui a suivi le projet de loi C-12.

[*Traduction*]

**Le président :** Ce serait un examen quinquennal plus approfondi plutôt qu'une révision de routine.

Je crains que nous ne nous éloignions des questions liées au travail pour parler plutôt de questions liées à l'industrie. Je serais très tenté de faire témoigner M. Carrie. Vous opposeriez-vous à ce que nous donnions la parole à M. Carrie?

**Le sénateur Harb :** Monsieur le président, si vous me le permettez, je dois partir sous peu et j'aimerais poser des questions au ministre.

I commend the minister for his presentation on the Wage Earner Protection Program, showing that it is important for this committee to deal with it as quickly as possible, given the unanimity out there.

So many questions remain unanswered, some less than others, on chapter 47 and its content. Does the minister think it wise for the committee to take the element dealing with Wage Earner Protection Programs Act and consider it separately so that it moves through the Senate as quickly as possible, given the potential for a change of government?

That would allow the committee, as well as the government and the administration, to deal with the other outstanding issues in light of the fact that chapter 47 will be studied soon. In that way, we can allow the stakeholders to dialogue and discuss and we can bring it in a reasonable fashion to this committee so we can give it the thorough study that it needs, rather than running like a chicken without its head because they are in a hurry to pass the bill. The more they change, the more they remain the same. This is exactly what happened to this committee when the previous government was in power. They came running to us to quickly pass the bill because waiting workers needed to be protected. They said that they would fix the bill later.

We are hearing the exact same thing from this government. Chair, with your permission, I want to ask a precise question of the minister. Will this bill deal with, in essence, the interests of both labourers and the people in the community to support his proposal and allow us to deal with the rest of the bill in a logical, comprehensive fashion.

**The Chair:** I permit the question, Senator Harb, on the condition that you will allow me to point out that we have explored on two occasions the possibility of carving out the Wage Earner Protection Act part of the bill and have been advised that it is not possible; it is all or nothing.

The minister is proposing that we move forward with it all on the understanding that officials are preparing a list of technical amendments that would improve the rest of the bill, depending on what we learn during the rest of the committee's hearings. Subject to that, please pursue your question.

[*Translation*]

**Mr. Blackburn:** Senator Harb, do you think that I did not look at the possibility that we could draft our own legislation in the Department of Labour without having to refer to other people? That would have been a lot easier and faster and it would have already gone through the process. But that is not what we did; we have collaborated on this and we have no choice.

But if we start to look at the other legislation on bankruptcy, insolvency, et cetera, we will be at it for ever. There is a group in society that we want to protect, that is wage earners whose employers declare bankruptcy. What we want to protect is their earnings.

Je félicite le ministre de son exposé sur le Programme de protection des salariés et d'avoir fait comprendre au comité qu'il est important de procéder rapidement, étant donné que ces dispositions font l'unanimité.

Il reste encore tant de questions sans réponse, à divers degrés, au sujet du chapitre 47 et de son contenu. Le ministre pense-t-il que le comité aurait intérêt à retirer du projet de loi les éléments relatifs au Programme de protection des salariés pour examiner cet élément séparément afin qu'il puisse être adopté par le Sénat aussi rapidement que possible, étant donné la possibilité d'un changement de gouvernement?

De cette façon, le comité de même que le gouvernement et l'administration, pourraient s'occuper des autres questions non réglées, étant donné que le chapitre 47 sera bientôt à l'étude. Cela permettrait aux interlocuteurs de dialoguer, et la mesure pourrait être présentée à notre comité de façon raisonnable afin que nous puissions en faire l'examen approfondi qu'elle mérite, plutôt que de courir dans tous les sens pour faire adopter rapidement le projet de loi. Plus ça change, plus c'est pareil. C'est exactement ce qui s'est produit à notre comité lorsque le gouvernement précédent était au pouvoir. On nous a demandé de nous presser d'adopter le projet de loi parce que les salariés attendaient ces mécanismes de protection. On nous a dit que les lacunes du projet de loi seraient corrigées plus tard.

C'est exactement ce que nous dit le gouvernement actuel. Monsieur le président, si vous me le permettez, je vais poser une question bien précise au ministre. Compte tenu de ce dont il est question dans le projet de loi, pense-t-il que les travailleurs et la population souhaitent que nous appuyions sa proposition et que nous examinions le reste du projet de loi de façon logique et complète?

**Le président :** Je vais autoriser cette question, sénateur Harb, mais je dois vous signaler auparavant que nous avons examiné à deux reprises la possibilité de traiter les articles relatifs à la Loi sur le programme de protection des salariés de façon distincte, et on nous a dit que ce n'était pas possible; c'est tout ou rien.

Le ministre propose que nous examinions l'ensemble du projet de loi, en sachant que les fonctionnaires préparent une liste d'amendements techniques qui amélioreront le reste de la mesure législative, selon ce que nous apprendrons durant nos audiences. Vous pouvez continuer de poser votre question, sous réserve de cela.

[*Français*]

**M. Blackburn :** Sénateur Harb, pensez-vous que je n'ai pas étudié cette possibilité que nous, au ministère du Travail, fassions nous-mêmes notre loi en n'ayant pas à nous référer aux autres? Cela aurait été beaucoup plus facile, beaucoup plus rapide et ce serait déjà réglé. Mais ce n'est pas ce que nous avons fait; nous sommes associés sur ce plan et nous n'avons pas le choix.

D'autre part, si on se met à revoir l'autre loi sur la faillite et l'insolvabilité et autres, on n'en finit plus. Il y ici un groupe que l'on veut protéger dans la société, ce sont les travailleurs qui vivent la faillite de l'entreprise qui les emploie. Ce qu'on veut protéger, c'est leur salaire.

If there are other flaws after one or two years of implementation, a report will be submitted to the minister responsible indicating that the bill was well intentioned but it contains a flaw.

Then the minister responsible will make the necessary change to a given provision. We cannot review everything because the process will never be finished, but we want to see if our objective is right and if the legislation to be amended meets that objective. If so, we need to move forward. Moreover, the bill was giving unanimous support in the House of Commons. I was not there at the time, before the current government was in office, but everyone said that employees' wages had to be protected.

That is why we are back here today with the unanimous support of Parliament.

[*English*]

**The Chair:** Mr. Carrie, do you want to make a preliminary comment?

**Mr. Carrie:** When looking at this, we do have to balance the competing interests. The wage earner protection part of it is very important in that balance. As Minister Blackburn said, we looked at all kinds of different ways of approaching this and in the spirit of balance; it does have to be moved forward together.

**Mr. Carrie:** Thank you very much. I want to begin by congratulating you on your chairmanship of this very important committee. As you said in your opening statement, you are a Conservative senator from Quebec. I believe it has been over 30 years since the last Conservative had the chair. Is that correct?

**The Chair:** Not quite, but it is certainly close to 20 years. Thank you for your thoughts.

**Mr. Carrie:** I would like to thank you for this opportunity to address the committee about Bill C-12, an act to amend the Bankruptcy and Insolvency Act, the Companies' Creditors Arrangement Act, and the Wage Earner Protection Program Act and chapter 47 of the Statutes of Canada, 2005.

I would like to begin by thanking Minister Blackburn for joining me here today and for his comments in respect of the Wage Earner Protection Program Act. Mr. Chair, I intend to focus my comments on the insolvency law portions of this bill.

Canada's insolvency laws are an important part of our framework legislation and play a key role in our competitiveness and economic performance in this era of increased globalization. With modern effective framework legislation, the Canadian economy will be stronger and Canadian entrepreneurs will be better placed to compete domestically and globally.

Former Bill C-55, now known as chapter 47 of the Statutes of Canada, 2005, or chapter 47, introduced broad reforms intended to modernize Canada's insolvency regime. The objectives of chapter 47 were to facilitate the restructuring of viable but financially troubled companies, to improve the

Si, dans un ou deux ans, à l'application, il y a des choses qui sont incorrectes, un rapport sera fait au ministre responsable disant que, avec cette loi, on avait une bonne volonté, mais qu'il y a telle lacune.

À ce moment-là, le ministre responsable apportera le correctif nécessaire sur un point. On ne veut pas revoir l'ensemble parce qu'on ne s'en sortira pas, mais on veut voir si notre objectif est bon et si, effectivement, les lois qu'on doit modifier tiennent compte de notre orientation. Si oui, il faut maintenant aller de l'avant. De plus, cela a été unanime à la Chambre des communes. Je n'y étais pas à ce moment, avant le gouvernement actuel, mais tout le monde a dit : oui, il faut protéger le salaire des employés.

C'est dans ce contexte que nous revenons aujourd'hui devant vous avec la volonté unanime du Parlement.

[*Traduction*]

**Le président :** Monsieur Carrie, avez-vous une déclaration préliminaire à faire?

**M. Carrie :** Dans cette mesure législative, il faut trouver un juste milieu entre les intérêts concurrents. La partie sur la protection des salariés est un élément très important de cet équilibre. Comme le ministre Blackburn l'a dit, nous avons envisagé toutes sortes d'approches, pour trouver cet équilibre; le projet de loi doit être adopté dans son ensemble.

**M. Carrie :** Merci beaucoup. Tout d'abord, permettez-moi de vous féliciter de présider ce très important comité. Comme vous l'avez dit au début de la réunion, vous êtes un sénateur conservateur du Québec. Voilà bien plus de 30 ans, n'est-ce pas, qu'un sénateur conservateur n'a pas occupé ce fauteuil?

**Le président :** Pas tout à fait, mais certainement près de 20 ans. Je vous remercie.

**M. Carrie :** Merci de m'avoir invité à venir parler devant le comité du projet de loi C-12, Loi modifiant la Loi sur la faillite et l'insolvabilité, la Loi sur les arrangements avec les créanciers des compagnies, la Loi sur le programme de protection des salariés et le chapitre 47 des Lois du Canada (2005).

J'aimerais tout d'abord remercier le ministre Blackburn de sa présence avec moi aujourd'hui et de ses commentaires concernant la Loi sur le Programme de protection des salariés. Monsieur le président, j'ai l'intention d'axer mes observations sur les portions du projet de loi relatives à la législation en matière d'insolvabilité.

En cette ère de mondialisation accrue, les lois canadiennes en matière d'insolvabilité forment une partie importante de notre cadre législatif et jouent un rôle clé dans notre compétitivité et notre rendement économiques. Un cadre législatif moderne et efficace permettra à l'économie canadienne d'être plus solide et aux entrepreneurs canadiens d'être plus concurrentiels à l'échelle nationale et internationale.

L'ancien projet de loi C-55, maintenant connu sous le nom de chapitre 47 des Lois du Canada (2005) ou de chapitre 47, introduisait de vastes réformes visant à moderniser le système d'insolvabilité au Canada. Les objectifs du chapitre 47 étaient de faciliter les restructurations d'entreprises viables mais éprouvant

protection of wage earners, to make the insolvency system fairer and reduce abuse, and to improve the administration of the entire system.

In meeting these objectives, chapter 47 created an appropriate balance between the competing interests of debtors and creditors and, as well, between different creditors. This is extremely important because it is crucial that our insolvency regime be designed to function efficiently and provide incentives to discourage abuse.

As you are aware, however, chapter 47 received expedited passage through Parliament. As a result, it contains a number of important technical flaws that prevent the government from bringing the law into force. Bill C-12, which is before you today, will correct those technical flaws.

Bill C-12 is the product of extensive consultations with a panel of leading insolvency law experts, both practitioners and academics. The panel assisted department officials in identifying the flaws and in determining workable solutions. In addition, department officials received input from a wide variety of stakeholder groups, including, for example, the Canadian Bar Association, the Canadian Life and Health Insurance Association and family law advocates.

In my comments, I have referred to chapter 47's technical flaws. That is deliberate. As Minister Blackburn has said, Bill C-12 can be considered as a piece of housekeeping legislation. It is not intended to re-examine the policy elements of chapter 47.

We have heard that insolvency reform is needed as soon as possible. Bill C-12 will achieve that goal. As I have said, chapter 47 found an appropriate balance to the competing interests inherent in insolvency policy. Where chapter 47 can be improved is in the details. It is for that reason that Bill C-12 takes the technical route — to fix the details, not to start over.

With that objective in mind, I would like to discuss some of those details that Bill C-12 will fix. I will focus on five examples: interim financing, trustee's personal liability, national receivers, equity claims and transfers at undervalue.

With respect to interim financing, chapter 47 codified the process by which companies in financial trouble obtain financing in order to give them breathing room while they restructure. Bill C-12 addresses two flaws contained in chapter 47.

First, Bill C-12 will require that secured parties be informed of any application for interim financing that may affect their interests. It is a matter of fairness that they should be entitled to defend their interests.

des difficultés financières, d'améliorer la protection des salariés, de rendre le système d'insolvabilité plus équitable et de réduire les abus et d'améliorer l'administration du système.

Pour atteindre ces objectifs, le chapitre 47 a créé un équilibre approprié entre les intérêts concurrents des débiteurs et des créanciers ainsi qu'entre les différents créanciers. Cela est extrêmement important parce qu'il est crucial que notre régime d'insolvabilité soit conçu de façon à permettre un fonctionnement efficace et à décourager les abus.

Comme vous le savez, le chapitre 47 a été adopté de façon accélérée par le Parlement. Aussi contient-il un certain nombre de défauts techniques qui empêchent le gouvernement de le mettre en vigueur. Le projet de loi C-12, qui est devant vous aujourd'hui, corrigera ces défauts techniques.

Le projet de loi C-12 résulte de longues consultations auprès d'un groupe d'éminents spécialistes en droit de l'insolvabilité, formé tant de praticiens que d'universitaires. Le groupe a aidé les fonctionnaires du ministère à cerner les défauts techniques et à mettre au point des solutions pratiques. En outre, les fonctionnaires du ministère ont obtenu des renseignements d'un grand éventail de groupes d'intervenants, dont l'Association du Barreau canadien, l'Association canadienne des compagnies d'assurances de personnes et des avocats spécialisés en droit de la famille.

Dans mes observations, j'ai fait référence aux défauts techniques du chapitre 47 de façon délibérée. Comme l'a déclaré le ministre Blackburn, le projet de loi C-12 peut être considéré comme un projet de loi d'ordre administratif. Il ne vise pas à réexaminer les éléments de politique du chapitre 47.

Nous avons compris qu'il fallait apporter des réformes au système d'insolvabilité le plus tôt possible. Le projet de loi C-12 permettra de réaliser cet objectif. Comme je l'ai mentionné, le chapitre 47 a trouvé le juste équilibre entre les intérêts concurrents inhérents à la politique en matière d'insolvabilité. C'est au niveau des détails que le chapitre 47 peut être amélioré. Le projet de loi C-12 emprunte donc la voie technique, à savoir celle de régler les détails et non de recommencer le travail.

Tout en gardant cet objectif à l'esprit, j'aimerais examiner brièvement certains détails que corrigera le projet de loi C-12. Je vais vous en donner cinq exemples : le financement provisoire, la responsabilité personnelle du syndic, les séquestres nationaux, les réclamations relatives aux capitaux propres, ainsi que les opérations sous-évaluées.

En ce qui a trait au financement provisoire, le chapitre 47 a codifié le processus permettant aux sociétés éprouvant des difficultés financières d'obtenir le financement qu'il leur assurera une marge de manœuvre pendant leur restructuration. Le projet de loi C-12 comble deux défauts du chapitre 47.

Premièrement, le projet de loi C-12 exige que les créanciers garantis soient informés de toute demande de financement provisoire pouvant avoir un effet sur leurs intérêts. Ils doivent avoir le droit de défendre leurs intérêts; c'est une question d'équité.

Second, it will also make it clear that the special status accorded to interim financing loans will only apply to money lent to help the company during the period of distress. Again, as a matter of fairness, debts that existed before an insolvency filing will not be entitled to jump ahead of other creditors.

With respect to trustee's personal liability, chapter 47 also attempted to address the problem where a trustee or a receiver is made personally liable for the obligations of the debtor. Trustees and receivers are insolvency practitioners whose role is to go in after an insolvency filing, take over the assets of the bankrupt company and, in some cases, run the business until a purchaser can be found. This is a going-concern sale. It is recognized that going-concern sales are more beneficial than closing the business. Evidence shows that creditors receive better recovery and that more jobs are saved.

Recent case law, however, has made it possible for the insolvency practitioner to be found personally responsible to pay existing debts of the company in these circumstances. This is not good for the insolvency system, and it is not fair to the trustee or the receiver.

The reform in chapter 47, however, did not do enough to prevent these obligations from being passed on to the trustee or receiver. The result is that trustees and receivers may not wish to take on files where this risk is present. This may leave creditors with smaller recoveries and employees out in the cold.

Bill C-12 makes it clear that a trustee or a receiver should not be personally responsible for existing obligations. To ensure that workers are not left without recourse, however, Bill C-12 also makes it clear that their claims continue against the new purchaser.

With respect to national receivers, chapter 47 created the concept of a national receiver appointed under the Bankruptcy and Insolvency Act. The goal was to improve efficiency in the insolvency system by allowing one person to deal with all of the debtor's property, wherever the property is located in Canada.

The provision in chapter 47 was not sufficient, however, because it did not provide a specific list of powers that the national receiver could rely upon. This may lead to differing rules, depending on where the receiver is appointed.

Bill C-12 provides a list of powers to provide guidance to the appointing court. In addition, it offers flexibility for the court to grant such other powers as the court thinks are appropriate on a case-by-case basis.

With respect to equity claims, chapter 47 introduced a reform to limit the rights of equity holders to receive payments under a restructuring plan. In bankruptcy, of course, an equity holder has

Deuxièmement, il permettra également de préciser que le statut particulier qui est accordé aux prêts consentis aux fins de financement provisoire ne s'appliquera qu'aux sommes prêtées pour aider l'entreprise pendant la période où elle est en difficulté. Encore une fois, par souci d'équité, les dettes qui existaient avant la proposition d'insolvabilité n'auront pas préséance sur celles des autres créanciers.

En ce qui concerne la responsabilité personnelle du syndic, le chapitre 47 a également tenté de résoudre le problème lorsque le syndic ou le séquestre est tenu personnellement responsable des obligations d'un débiteur. Les syndics et les séquestres sont des praticiens de l'insolvabilité qui entrent en scène après le dépôt d'une procédure d'insolvabilité, prennent le contrôle des actifs de la société en faillite et qui, dans certains cas, dirigent l'entreprise jusqu'à ce que l'on trouve un acquéreur. Cela s'appelle une vente d'entreprise en exploitation. Il est reconnu qu'il est plus rentable de vendre une entreprise en exploitation que de procéder à sa fermeture. Les faits montrent que les créanciers obtiennent un meilleur rétablissement et que plus d'emplois sont sauvegardés.

Un jugement récent a toutefois permis de tenir un professionnel de l'insolvabilité personnellement responsable du paiement des dettes courantes de la compagnie dans certaines circonstances. Cette approche n'est guère appropriée pour le régime d'insolvabilité et est injuste à l'égard du syndic ou du séquestre.

L'amendement du chapitre 47 n'a toutefois pas suffi à éviter que ces obligations soient transmises au syndic ou au séquestre. Par conséquent, il peut arriver que les syndics et les séquestres refusent des affaires au motif qu'elles présentent un risque — ce qui se traduit pour les créanciers par une réduction des montants recouvrés et, pour les travailleurs, par des pertes d'emplois.

Le projet de loi C-12 établit clairement qu'un syndic ou un séquestre ne peut être tenu personnellement responsable d'obligations existantes. Pour éviter que les travailleurs se retrouvent sans recours, le projet de loi C-12 établit clairement que les réclamations de ceux-ci seront maintenues auprès du nouvel acheteur.

En ce qui concerne les séquestres nationaux, le chapitre 47 a introduit le concept de séquestre national nommé en vertu de la Loi sur la faillite et l'insolvabilité. Cet ajout avait pour objectif d'accroître l'efficacité du régime d'insolvabilité en permettant à une seule personne de traiter tous les biens du failli, où que ceux-ci soient situés au Canada.

Les dispositions du chapitre 47 n'étaient toutefois pas suffisantes parce qu'elles n'établissaient pas clairement les pouvoirs sur lesquels pouvait se fonder le séquestre national. Cette lacune pouvait être source de règles divergentes selon le lieu de nomination du séquestre.

Le projet de loi C-12 donne une liste de pouvoirs qui guidera le tribunal chargé de la nomination. En outre, il donne suffisamment de latitude au tribunal, permettant à ce dernier d'octroyer les pouvoirs qu'il jugera nécessaires, selon le cas.

En ce qui concerne les réclamations relatives à des capitaux propres, le chapitre 47 introduisait une modification visant à restreindre la possibilité, pour les actionnaires, de recevoir des

no right to be paid for their shares until all claims against the company are paid. In a restructuring, because it is a matter of negotiation, the rights of equity holders are not clear. It is possible for equity holders to get paid when other creditors are not. This is a problem as equity holders should not have greater rights in a restructuring than they would in a bankruptcy. Bill C-12 will correct this.

First, a definition of "equity claim" has been introduced. This clarifies that equity claims include items like dividend payments, return of capital, a right to have the company buy back your shares, a loss on the value of your shares and the right to be indemnified by the company for losses on the value of those shares. Second, an explicit amendment is included to prevent, during the restructuring, an equity claim receiving a payment unless all other claims are paid in full first. Third, the right of shareholders to vote on changes to the corporate structure is removed. Instead, that power has been given to the court. The Bill C-12 amendments will complete the reform started by chapter 47 by providing more clarity and explicit rules.

Chapter 47 also made amendments to the anti-abuse mechanism in the BIA related to efforts by unscrupulous debtors who try to shield their assets. Bill C-12 clarifies how the provisions will apply, and by doing so, makes them more efficient tools against potential abuse. At the same time, an amendment is made to the definition of "arm's length parties" to ensure that these provisions do not inadvertently capture legitimate family law agreements.

In conclusion, Mr. Chair, I have spent my time today explaining how Bill C-12 will improve on chapter 47. I have done so because Bill C-12 represents the best opportunity to bring chapter 47 into force quickly.

While there may be some stakeholders who want to reopen the debate on how chapter 47 balanced the many competing interests, doing so will only bring further delay when insolvency practitioners are telling us that insolvency reform is needed right now.

As members of this committee are aware, chapter 47 contains a five-year legislative review clause that will provide an opportunity to re-examine these and other policy debates.

Mr. Chair, on behalf of Minister Prentice, let me thank the committee for giving the opportunity to speak to this important piece of legislation today. I am pleased to respond to your questions.

paiements dans le cadre d'un plan de restructuration. Bien entendu, en cas de faillite, un actionnaire ne peut recevoir un paiement en échange de ses actions tant que toutes les réclamations visant la compagnie ne sont pas réglées. Dans le cas d'une restructuration, parce qu'il s'agit d'une affaire négociée, les droits des actionnaires ne sont pas clairs. Il est possible pour les actionnaires de recevoir un paiement, contrairement à d'autres créanciers. C'est un problème, car les actionnaires ne devraient pas avoir plus de droits lors d'une renégociation que lors d'une faillite. Le projet de loi C-12 va y remédier.

Premièrement, le projet définit la notion de réclamations relatives à des capitaux propres. Il précise que les réclamations relatives à des capitaux propres comprennent notamment les dividendes, les remboursements de capital, le droit de rachat d'actions au gré de l'actionnaire, les pertes attribuables à la diminution de la valeur des actions et le droit de recevoir une indemnité de la compagnie relativement à une diminution de la valeur des actions. Deuxièmement, le projet de loi apporte des amendements explicites pour veiller à ce que, dans le cadre d'une restructuration, le paiement d'une réclamation relative à des capitaux propres puisse avoir lieu seulement si le paiement intégral de toutes les autres réclamations a été effectué. Troisièmement, les actionnaires n'ont plus droit de vote sur la modification de la structure organisationnelle; ce droit est plutôt accordé au tribunal. Les modifications prévues par le projet de loi C-12 boucleront la vague de modifications lancée par le chapitre 47 en apportant plus de clarté, ainsi que des règles précises.

Pour empêcher les créanciers sans scrupule de tenter de camoufler leurs actifs, le chapitre 47 modifiait également les mécanismes établis dans la LFI en vue d'éviter les abus. Le projet de loi C-12 précise comment les dispositions s'appliqueront et, ce faisant, font de ces dispositions de meilleures armes contre d'éventuels abus. Parallèlement, la définition de l'expression « sans lien de dépendance » est clarifiée pour éviter que ces dispositions n'englobent malencontreusement les ententes légitimes en droit familial.

En conclusion, monsieur le président, j'ai expliqué aujourd'hui en quoi le projet de loi C-12 améliorera le chapitre 47. Ce projet de loi est la voie à suivre pour mettre rapidement en vigueur le chapitre 47.

Certains souhaitent rouvrir le débat sur la mesure dans laquelle le chapitre 47 constituait un juste équilibre entre de nombreux intérêts concurrents, mais cela ne ferait que repousser davantage une réforme que réclament les professionnels de l'insolvabilité.

Comme le savent les membres du comité, le chapitre 47 prévoit un examen de la loi cinq ans après son entrée en vigueur, ce qui donnera l'occasion de se pencher de nouveau sur ces dispositions, entre autres sujets de débat.

Monsieur le président, au nom du ministre Prentice, je remercie le comité de m'avoir donné l'occasion de parler aujourd'hui de cet important projet de loi. Je serai heureux de répondre à vos questions.

**The Chair:** Thank you, Mr. Carrie. Before I ask Senator Ringuette to proceed with the questioning, I think it is very important that we get on the record the following clarification, because there is at least a modest misunderstanding flowing from your last remarks.

The reality is that chapter 47 and Bill C-55 were never examined. We just flushed them through as requested on the condition that the whole bill would come to us. We have many witnesses that are going to come and debate about the substance of chapter 47.

It is not just technical amendments we are interested in here. It needs to be clearly stated that we have no intention of not examining the substance and merits of Bill C-55 from a policy point of view because we never did. That was the whole point.

The reason it was held up when the election was being called and so on was because we already knew from the officials that there were all these amendment that are set forth in Bill C-12. However, we had not yet studied them. We get all these calls about the need to do so. Just have no illusions; we will do an analysis.

[*Translation*]

**Senator Ringuette:** I am pleased to see this bill that was introduced by my former colleague the Honourable Joe Fontana two and a half year ago. This bill to protect employees' wages when employers declare bankruptcy is welcome legislation, in my view.

I am interested in the provision relating to student loan programs.

[*English*]

I am looking at Ms. Frith because I think that she and her associate are probably the best people to provide the answers I am looking for.

What would be the average interest rate for a student loan?

**Ms. Frith:** I am not sure of the average interest rate. I can tell you what the interest rate is for students graduating today who would consolidate their loans. It would be prime plus 2.5 per cent for a variable rate; if they choose a fixed rate, it would be prime plus 5 per cent. The bulk of students choose a variable rate, so today they are paying 8.75 per cent.

Do not forget that is for the direct loans today. There are still people who are on the guaranteed loan regime and on the risk-shared loan regime. They pay different interest rates, depending on when they graduated and consolidated their loans.

**Senator Ringuette:** The fixed loan would be prime plus what percent?

**Le président :** Merci, monsieur Carrie. Avant d'inviter le sénateur Ringuette à poser ses questions, je pense qu'il est très important d'apporter au compte rendu la précision suivante, car la fin de vos propos laisse planer au moins un léger malentendu.

En réalité, le chapitre 47 et le projet de loi C-55 n'ont jamais été examinés. Nous en avons précipité l'adoption comme on nous l'avait demandé, à condition que l'ensemble du projet de loi nous parvienne par la suite. De nombreux témoins vont venir débattre de la teneur du chapitre 47.

Nous ne nous intéressons pas qu'à des amendements d'ordre technique. Il doit être bien établi que nous n'avons nullement l'intention de renoncer à l'examen de la teneur et du bien-fondé du projet de loi C-55 du point de vue de sa valeur prescriptive, car nous ne l'avons pas encore fait jusqu'à maintenant. Voilà ce que je tenais à dire.

Si cette mesure est restée en suspens lors du déclenchement des élections, c'est parce que les fonctionnaires nous avaient déjà dit que tous ces amendements figureraient dans le projet de loi C-12, que nous n'avions pas encore étudié. Nous avons reçu de nombreux appels où l'on faisait état de l'impérieuse nécessité de l'étudier. Ne vous faites donc aucune illusion, nous allons l'analyser.

[*Français*]

**Le sénateur Ringuette :** Je suis heureuse de l'arrivée de ce projet de loi proposé par mon ancien collègue, l'honorable Joe Fontana, il y a deux ans et demi. Ce projet de loi pour la protection des salaires des employés, qui sont aux prises avec une entreprise insolvable est un élément de législation qui, pour ma part, est le bienvenu.

Mon champ d'intérêt se situe au niveau des programmes de prêts aux étudiants.

[*Traduction*]

Je jette un regard vers Mme Frith, parce que je pense que c'est elle et la personne qui l'accompagne qui sont sans doute les mieux placées pour me donner les réponses que j'attends.

Quel est le taux d'intérêt moyen d'un prêt aux étudiants?

**Mme Frith :** Je ne le sais pas exactement. Je peux vous indiquer le taux d'intérêt applicable à un étudiant diplômé qui voudrait consolider son prêt. C'est le taux préférentiel augmenté de 2,5 p. 100 pour un taux variable; si l'étudiant choisit un taux fixe, ce sera le taux préférentiel plus 5 p. 100. La plupart des étudiants choisissent le taux variable; ils payent donc actuellement 8,75 p. 100 d'intérêts.

N'oubliez pas qu'il s'agit là de la situation actuelle des prêts directs. Il y a encore des gens qui relèvent des régimes des prêts garantis et des prêts à risques partagés, qui sont assortis de taux d'intérêts différents, selon les dates d'obtention du diplôme et de consolidation du prêt.

**Le sénateur Ringuette :** Le prêt à taux fixe comporte donc le taux préférentiel augmenté de quel pourcentage?

**Ms. Frith:** Prime plus 5 per cent, so an additional 6.25 per cent for prime.

**Senator Ringuette:** 11.25 per cent?

**Ms. Frith:** Yes.

**Senator Ringuette:** I think that would be okay for a luxury good, but an education is not a luxury good.

How many students have student loans?

**Ms. Frith:** We have over one million active files. We have about 340,000 new students coming into the system annually.

**Senator Ringuette:** Concerning the two programs you mentioned earlier, to help the students, you have talked about the nine months' interest relief. How much would that cost your department? Let us look at last year.

**Ms. Frith:** There is not a nine-month interest relief program. There is an interest relief program that can be used for up to five years.

**Senator Ringuette:** Does it start after nine months?

**Ms. Frith:** I would have to come back with the exact figures. For 2004-05, I believe it was $64 million that the government expended on interest relief.

**Senator Ringuette:** What about the other one — you said that it was the debt relief program.

**Ms. Frith:** Debt reduction.

**Senator Ringuette:** You said that they can apply to it after five years, actually after the 16 months' interest relief has expired.

**Ms. Frith:** That is correct. That program only came into effect two years ago. I am sorry but I cannot remember the exact figures for it. I can provide you with all of the costs to the program.

**Senator Ringuette:** I would appreciate that. I am looking at an article that appeared in the paper in Halifax dated November 27.

**Ms. Frith:** I am familiar with the article.

**Senator Ringuette:** I am sure that you are very familiar with the article. If you have effective communications people, then you would know about it. The article indicates that a recent Access to Information request has revealed that the government is charging students nearly double what it costs to borrow the money for student loans. In currency terms, that means the federal government would pocket $549.5 million in interest revenue throughout 2009-10. This was an excellent initiative from a young student from Vancouver through the Access to the Information Act, so he had to jump a lot of hurdles to get this information. The article indicates that it was Vancouver's Julian Benedict who started the Coalition for Student Loan Fairness that made the Access to Information request. Benedict made other discoveries with his request. The government has recovered more than $1 billion on defaulted student loans — bravo — and $180.8 million was paid to collection agencies to gather that money. Roughly 20 per cent of what you collected went to collection agencies, if the article is correct. The rate, whether you

**Mme Frith :** Le taux préférentiel plus 5 p. 100, soit 6,25 p. 100 pour le taux préférentiel.

**Le sénateur Ringuette :** Pour un total de 11,25 p. 100?

**Mme Frith :** Oui.

**Le sénateur Ringuette :** Ce serait raisonnable pour un produit de luxe, mais l'éducation n'est pas un produit de luxe.

Combien d'étudiants ont obtenu ce genre de prêt?

**Mme Frith :** Nous avons plus d'un million de dossiers actifs. Environ 340 000 étudiants obtiennent un prêt chaque année.

**Le sénateur Ringuette :** Vous avez parlé tout à l'heure de deux programmes destinés à aider les étudiants, notamment une exemption d'intérêts pendant neuf mois. Qu'est-ce qu'il en coûte à votre service? Prenons le cas de l'année dernière.

**Mme Frith :** Il n'y a pas de programme d'exemption d'intérêts sur neuf mois. Le programme d'exemption d'intérêts peut s'appliquer sur une période maximale de cinq ans.

**Le sénateur Ringuette :** Cela commence-t-il après neuf mois?

**Mme Frith :** Il faudrait que je vérifie pour vous donner les chiffres exacts. Pour 2004-2005, le gouvernement a, je crois, dépensé 64 millions de dollars en allègements d'intérêts.

**Le sénateur Ringuette :** Et l'autre — vous avez dit qu'il s'agissait du programme d'allègement de la dette.

**Mme Frith :** De réduction de la dette.

**Le sénateur Ringuette :** Vous avez dit qu'ils pouvaient en faire la demande après cinq ans, en fait après l'expiration de la période de 16 mois d'allègement des intérêts.

**Mme Frith :** C'est exact. Le programme n'est entré en vigueur qu'il y a deux ans. Vous voudrez bien m'excuser, mais je ne me souviens pas des chiffres exacts. Je pourrais vous les faire parvenir en même temps que le total des coûts du programme.

**Le sénateur Ringuette :** Je vous en saurais gré. Je regarde ici un article qui a paru le 27 novembre à Halifax.

**Mme Frith :** Je le connais bien.

**Le sénateur Ringuette :** Je n'en doute pas. Si vos responsables des communications sont bons, il est certain que vous devez être au courant. Cet article révèle qu'une demande d'accès à l'information introduite récemment a montré que le gouvernement exigeait des étudiants un taux d'intérêt qui est quasiment le double de ce qu'il lui en coûte pour emprunter l'argent qu'il verse en prêts étudiants. Cela signifie que le gouvernement fédéral empocherait 549,5 millions de dollars en intérêts pour l'exercice 2009-2010. Il s'agissait en l'occurrence d'une excellente initiative d'un jeune étudiant de Vancouver qui a fait cette demande d'accès à l'information, mais il a dû franchir de nombreux obstacles pour obtenir gain de cause. L'article mentionne son nom, il s'agit de Julian Benedict, un étudiant de Vancouver qui a fait la Coalition for Student Loan Fairness, l'organisme qui avait introduit cette demande d'accès à l'information. Grâce à cette demande, Benedict a également découvert autre chose. Le gouvernement a récupéré plus d'un milliard de dollars en prêts étudiants en défaut — bravo — mais il

are looking at variable or fixed rate on student loans, goes from 8.75 per cent to 11.5 per cent. That is where over $500 million in interest revenue is projected.

**Ms. Frith:** Yes.

**Senator Ringuette:** Yet for the two programs that you have in place, you can only tell me that last year one of them cost $64 million, and the new one that was put in place two years ago is too new so you cannot provide me with the figures.

The bottom line is what are we really doing for students? How are we really encouraging them? I am astonished, looking at the interest rate that we are charging these students. It should be maximum prime, because this is an investment not only in an individual future but a collective investment into Canada's future.

**The Chair:** Senator, if I may, I have been letting you go on because I think it is very interesting for the minister and the parliamentary secretary to hear this information. I must point out to you that this bill does not deal with the administration of the program. It does provide some relief, but the student loan program is a totally different matter. I am letting you go on, but not for long.

**Senator Ringuette:** It is an issue. We are talking about student loan insolvency, students having to declare bankruptcy, and wherever there is an effect, there is a cause. I am looking at the elements of cause.

**The Chair:** As I said, senator, up to now I have let you go on. Perhaps you would be crisp with your questions. You have raised an interesting point that is not in this bill. We have heard that it is important that we hear about 23 witnesses, and I think it is very important that the government take note of the problem you have raised. If you would like to ask questions, I am allowing them, but please get going with them rather than have a public policy discussion.

**Senator Ringuette:** Let me specify that Ms. Frith will look into the cost of the new debt relief program and provide that information to you, chair.

As well, did I hear you saying that there was a current review of the scheme of student loans?

**Ms. Frith:** You have raised two issues. Just on the interest issue, to make it very clear, in 2009-10, I believe it was about $549 million that Mr. Benedict said we would be collecting in

a payé 180,8 millions de dollars aux organismes de recouvrement qui ont récupéré ces sommes. En fait, 20 p. 100 environ de ce que vous avez récupéré a été payé à des agences de recouvrement, à en croire cet article. Le taux d'intérêt qui frappe les prêts étudiants va de 8,75 p. 100 à 11,5 p. 100 selon qu'il s'agit d'un taux variable ou d'un taux fixe. C'est ainsi qu'on arrive à ce total de plus de 500 millions de dollars en intérêts perçus.

**Mme Frith :** En effet.

**Le sénateur Ringuette :** Et pourtant, pour les deux programmes que vous avez actuellement, vous pouvez uniquement me dire que l'an dernier, l'un des deux a coûté 64 millions de dollars et que le nouveau, celui qui a été introduit il y a deux ans, est trop nouveau pour que vous puissiez me le chiffrer.

Mais en bout de ligne, que faisons-nous vraiment pour les étudiants? Que faisons-nous vraiment pour les encourager? Je suis étonnée, lorsque je vois les taux d'intérêt qu'on leur demande. On devrait leur demander au maximum le taux préférentiel étant donné qu'il s'agit d'un investissement que nous faisons non seulement dans l'avenir de l'étudiant, mais également, sur un plan collectif, dans l'avenir du Canada.

**Le président :** Avec votre indulgence, madame le sénateur, je vous ai laissée poursuivre parce qu'à mon avis il est très intéressant pour le ministre et son secrétaire parlementaire d'entendre ce genre de choses. Je dois toutefois signaler que le projet de loi ne concerne pas l'administration du programme. Il prévoit des mesures d'allègement, mais le Programme de prêts aux étudiants est complètement différent. Je vous laisse poursuivre, mais pour un temps limité.

**Le sénateur Ringuette :** C'est un problème. Nous parlons ici de l'insolvabilité des prêts étudiants, des étudiants qui doivent déclarer faillite, et là où il y a un effet, il y a une cause. Ce qui m'interpelle ici, ce sont les éléments de cette cause.

**Le président :** Comme je viens de vous le dire, madame le sénateur, je vous ai laissée poursuivre jusqu'à présent. Peut-être pourriez-vous resserrer un peu vos questions. Vous avez fait valoir quelque chose d'intéressant mais qui ne se trouve pas dans le projet de loi. On nous a dit qu'il fallait absolument entendre environ 23 témoins, et à mon avis, il faut aussi que le gouvernement prenne bonne note du problème que vous avez soulevé. Si vous voulez maintenant poser des questions, je vais vous laisser faire, mais je vous en prie, énoncez-les au lieu de poursuivre une discussion axée plutôt sur la politique publique.

**Le sénateur Ringuette :** Laissez-moi simplement confirmer que Mme Frith va se renseigner sur le coût du nouveau programme d'allègement de la dette et vous transmettre à vous, le président, l'information demandée.

Par ailleurs, vous ai-je bien entendu dire que vous procédiez actuellement à un examen de l'ordonnancement des prêts étudiants?

**Mme Frith :** Vous avez évoqué deux choses. En ce qui concerne simplement la question de l'intérêt, et pour être très clair, en 2009-2010 je crois, c'est environ 549 millions de dollars que

interest. I would just like to note that in 2009-10 we are also forecasting the total cost to the program will be $1.2 billion, which is more than twice what we will recover.

I just want to make it very clear that the while the person is in school there is no interest charged whatsoever. That is a cost to the government. When the student graduates, leaves school and commences repayment, he or she is given a choice between the variable rate and the fixed rate. Over 95 per cent take the variable rate, not the fixed rate, which I understand is very high. For those graduates who are unable to make payments, there is interest relief, a reduction in repayment, or a revision of terms. The latter option means that the student may pay back the loan over 15 years instead of the normal term of 10 years. In addition to that, there are textbook tax credits the students are given each year. On top of that, students are eligible for a tax credit on the interest paid on the loan, which in fact reduces the overall interest rate by 1 per cent to 1.5 per cent.

In effect, it is clearly costing the government more than twice as much as what is recovered in interest payments. I will bring you the exact costs for one of our most recent years so that you can see the difference between what we are collecting and what we are paying out.

**Senator Ringuette:** Thank you very much, and I appreciate the information you will be providing.

**The Chair:** We are hoping that this piece of information that came out during our consideration of Bill C-12 will be communicated to your colleagues in the cabinet.

[*Translation*]

**Mr. Blackburn:** Basically, Mr. Chairman, that is true to some extent; you said that scholarships were administered by another department. I find this exchange interesting, and I think that we have seen the real costs to government of this. This is also something we need to look at. When a student has difficulty paying back his or her loan for some major reason, it is always possible to discuss the problem with the authorities to have the repayment period or the terms reduced.

It is somewhat similar to income tax. Where a taxpayer has set monthly amounts of tax to pay, they can call the authorities and reach an agreement if their standard of living changes because they are earning less than before. When people act in good faith, a solution can generally be found.

With what we are doing today to protect wage earners with this legislation, we estimate that the annual cost to government will be around $37.5 million a year. If more people were to declare bankruptcy and more workers were affected, the amount could potentially reach $50 million.

nous allions, selon M. Benedict, percevoir en intérêts. J'aimerais simplement faire valoir qu'en 2009-2010, nous avons également prévu que le programme coûterait en tout 1,2 milliard de dollars, c'est-à-dire plus de deux fois ce que nous allons recouvrer.

Je voudrais également préciser très clairement que, tant que l'étudiant poursuit ses études, aucun intérêt ne s'ajoute à sa dette. Les frais d'intérêt sont à la charge du gouvernement. Lorsqu'il obtient son diplôme, quitte l'université et commence à rembourser, l'étudiant a le choix entre un taux d'intérêt variable et un taux d'intérêt fixe. Plus de 95 p. 100 optent pour le taux variable et non pas le taux fixe, qui est très élevé ai-je cru comprendre. Si un étudiant diplômé est incapable de rembourser, on lui offre d'alléger le service de sa dette, de réduire ses remboursements ou de revoir la période de remboursement de son prêt. Dans le dernier cas, cela veut dire que l'étudiant a le loisir de rembourser son prêt sur 15 ans au lieu de dix ans, ce qui est la durée normale. En plus, il a droit chaque année à un crédit d'impôt pour les manuels scolaires. Mieux encore, les étudiants ont droit à un crédit d'impôt pour l'intérêt payé sur leurs dettes, ce qui a pour effet de réduire de 1 à 1,5 p. 100 le taux d'intérêt réel qui grève leurs dettes.

En réalité, cela coûte au gouvernement, c'est clair, plus de deux fois ce que celui-ci récupère en intérêts. Je vais vous faire parvenir le chiffre exact de ce qu'il lui en coûte pour les années les plus récentes afin que vous puissiez voir la différence entre ce que nous percevons et ce que nous décaissons.

**Le sénateur Ringuette :** Merci beaucoup pour l'information que vous allez nous fournir.

**Le président :** Nous espérons que ce que nous avons ainsi appris pendant notre examen du projet de loi C-12 sera communiqué à vos collègues du Cabinet.

[*Français*]

**M. Blackburn :** En somme, monsieur le président, c'est un peu vrai; vous disiez que les modalités des bourses relevaient d'un autre ministère. Je trouve l'échange intéressant et je pense qu'on a vu ce qu'il en était pour les coûts réels pour le gouvernement. C'est aussi un point sur lequel on doit revenir. Quand un étudiant a de la difficulté à rembourser son prêt pour une raison importante, on peut toujours discuter avec les autorités en question pour diminuer notre terme, diminuer notre façon de payer.

C'est un peu la même chose pour l'impôt. Pour un contribuable qui arrive à un point où il avait des remboursements d'impôts fixes à faire à raison de tel montant par mois, si d'un coup son niveau de vie change parce que son emploi est moins rémunérateur qu'auparavant, il peut appeler les autorités et refaire une entente avec eux. Quand les gens sont de bonne foi, en général, des solutions sont possibles.

Avec ce que l'on est en train de faire aujourd'hui pour la protection des salariés avec cette loi, on estime que le coût annuel pour le gouvernement, gravitera autour de 37,5 millions dollars par année et potentiellement, dans le cas de scénarios où plus de gens feraient faillite et plus de travailleurs seraient affectés, cela pourrait atteindre jusqu'à 50 millions.

Taxpayers and parliamentarians wanted workers affected by employer bankruptcies not to have to wait forever to be paid. The government will take charge of the situation and Service Canada will assist workers. They will explain the situation, indicate the amount of earnings they have lost over how many weeks, and Service Canada will pay them so that they do not have to wait until the end of the process. The government will then deal with the company and will seek reimbursement if there are assets remaining.

**Senator Biron:** Welcome, Mr. Blackburn. My question is along the same lines as that of Senator Ringuette, concerning the Registered Education Saving Plans.

Students, after all, are not responsible for choosing their elders, and they are not responsible for their bankruptcy. As Senator Ringuette mentioned, it is in the interest of a country to have a well-educated population; when students do not have enough money to finish their education, it is a great loss for the country.

Moreover, the losses incurred by creditors who participate in the education savings plan are relatively low because the average loan amounted to $10,000, divided by a certain number of creditors. This could amount to a few hundred dollars per creditor. However, it is a tremendous loss for the student. In addition, the cost of education is constantly going up.

Could we find some way to arrange that payments made by a benefactor become the property of the student? I understand that the education savings plan has a very complicated structure, but I think that it could be an interesting possibility.

**Mr. Charland:** Would you please clarify your question?

**Senator Biron:** Could we try to find an arrangement whereby the funds contributed by a benefactor to the education savings plan eventually become the student's property or the property of the person in whose name the funds were contributed?

**Mr. Charland:** This question does not fall under my purview. It really has nothing to do with Bill C-12 or with what we are doing now.

**Senator Biron:** It was just meant to inform Mr. Blackburn. Eventually, he might discuss it with others. It is a suggestion.

**Mr. Blackburn:** If we accept this as a suggestion, we can, in fact, look at ways of arranging this, if it can be done. It is worth looking at. We listen to suggestions from taxpayers and citizens and we try to follow up on them. We will see what we can do.

**The Chair:** It is a good suggestion, Senator Biron.

Les contribuables et les parlementaires voulaient que le travailleur affecté par la faillite de la compagnie, n'attende pas indéfiniment avant d'être payé. C'est le gouvernement qui prendra en charge la situation et c'est le programme Service Canada qui interviendra au niveau du travailleur. Le travailleur expliquera sa situation, quelle perte de salaire il a eue, pendant combien de semaines, et c'est Service Canada qui aura à payer le travailleur pour qu'il n'attende pas dans le processus. Pour sa part, le gouvernement se tournera vers l'entreprise et s'il reste des actifs, s'assurera de se faire rembourser.

**Le sénateur Biron :** Bonjour, monsieur Blackburn. Ma question rejoint celle du sénateur Ringuette et concerne le Régime enregistré d'épargne-études.

Il faut comprendre qu'un étudiant n'est pas responsable du choix de son parrain, de même qu'il n'est pas responsable de sa faillite. Comme le mentionnait le sénateur Ringuette, il en va de l'intérêt supérieur d'un pays que la population soit instruite; lorsqu'un étudiant ne peut compléter ses études par manque de fonds, c'est donc une très grande perte pour le pays.

Par ailleurs, la perte des créanciers suivant l'épargne-études est relativement faible parce que la moyenne des prêts était de 10 000 $, divisés par un certain nombre de créanciers, cela pouvait représenter quelques centaines de dollars par créancier, alors que la perte pour l'étudiant est immense. Et les coûts des études ne cessent d'augmenter.

Y aurait-il un moyen de faire en sorte que les versements faits par un bienfaiteur soient acquis pour l'étudiant? Je comprends que la structure des régimes d'épargne-étude est très complexe, mais je crois qu'il serait intéressant d'étudier cette possibilité.

**M. Charland :** Pourriez-vous préciser votre question, s'il vous plaît?

**Le sénateur Biron :** Ne pourrions-nous pas envisager la possibilité que lorsqu'un bienfaiteur verse un montant dans le régime d'épargne-études, qu'éventuellement ces sommes deviennent acquis à l'étudiant ou à celui au nom duquel le montant a été versé?

**M. Charland :** Cette question n'est pas de mon ressort. Cela ne touche pas vraiment le projet de loi C-12 ni notre champ d'activité.

**Le sénateur Biron :** C'est pour que M. Blackburn soit au courant. Il pourrait alors en parler à d'autres. C'est une suggestion.

**M. Blackburn :** À partir du moment où c'est une suggestion, on peut effectivement regarder comment on peut rendre accessible cet aspect, et voir si on peut mettre l'idée en pratique. Cela mérite d'être regardé. C'est comme écouter les suggestions des contribuables et des citoyens. On essaie de donner suite à ces suggestions. On va regarder ce qu'on peut faire.

**Le président :** C'est une bonne suggestion, sénateur Biron.

[*English*]

**Senator Moore:** This committee studied the Bankruptcy and Insolvency Act in 2003, and prepared a highly detailed report with 53 recommendations.

Mr. Carrie, in your comments I did not see any reference to the committee's report among the things that you looked at when you talked with stakeholders and so on. The chair of the committee played a big role in the work of that report. I did not see any reference to the chair or the report.

Mr. Carrie, I do not know whether you looked at our report but one of the recommendations contained therein was that RESPs be protected so that the students not lose the money set aside for education because of the actions of the contributor to the plan. That is an important point. I know that the senator brought in a draft bill last year and time ran out on it. Have you read the report?

[*Translation*]

**Mr. Blackburn:** You know that this bill, before it went to the Senate, was amended twice due to a motion by the Quebec government that did not want the provincial RRSPs to be involved in this. There were various opinions about it. Some thought that if someone invested in an RRSP within the 12 months preceding the bankruptcy, that the money invested within those 12 months could be recovered, but not the money invested before that.

We had to have a consensus, and that is why we heeded the recommendation to leave RRSPs out of this. Mr. Carrie could tell you more about it.

[*English*]

**Mr. Carrie:** We looked at that report and at its successor, which was tabled in 2005. Concerning the RESPs, a thorough review showed that an exemption would be rife for abuse under the program for three reasons. The first reason is the debtor may access the capital that he or she contributed to the plan at any time; second, the assets are not restricted to be used by the child only for educational purposes; and third, a debtor can open multiple RESPs. That is why we did not do that.

**Senator Moore:** Could we not add a kind of pay cut-off date to prevent that abuse? For example, if a man owns a business and sees by his statements that things are not going well and the business might crash, he could decide to tuck away $20,000 or $50,000 in the business for his grandson's education. Could we not have a provision that would enable RESPs to be protected as long as the deposits were made at 12 months or 18 months?

**Mr. Carrie:** The point raised would promote a good debate. I would like to clarify that Bill C-12 is more or less the technical solution.

[*Traduction*]

**Le sénateur Moore :** Le comité a étudié en 2003 la Loi sur la faillite et l'insolvabilité et il a dressé un rapport très détaillé assorti de 53 recommandations.

Monsieur Carrie, vous n'avez pas mentionné dans votre intervention le rapport du comité comme faisant partie de tous les éléments que vous avez examinés lorsque vous vous êtes entretenu avec les parties intéressées. Le président du comité a joué un rôle très important dans le cheminement de ce rapport et je n'ai pas vu non plus que vous l'ayez nommé, pas plus que vous n'avez mentionné le rapport.

Monsieur Carrie, j'ignore si vous avez consulté notre rapport, mais l'une des recommandations que nous y faisions était que les REEE devaient être protégés afin que les étudiants ne perdent pas l'argent qui a été mis de côté pour leurs études par la faute du cotisant au régime. La chose est importante. Je sais que le sénateur a, l'an dernier, déposé un avant-projet de loi qui n'a malheureusement pas eu le temps de poursuivre sa route. Avez-vous lu notre rapport?

[*Français*]

**M. Blackburn :** Vous savez que le projet de loi, avant qu'il ne soit soumis au Sénat, a subi deux amendements après une motion du gouvernement du Québec qui souhaitait qu'on ne vienne pas toucher aux REER de la province. Il y avait différents points de vue à ce sujet. Certains pensaient que si une personne mettait de l'argent dans un REER dans les 12 mois précédant la faillite, qu'on puisse récupérer l'argent placé dans son REER à l'intérieur des 12 mois, mais non les sommes accumulées avant.

Il a fallu en arriver à un consensus et c'est pour cela qu'on a tenu compte de cette recommandation de ne pas toucher aux REER. M. Carrie pourra vous en dire plus à ce sujet.

[*Traduction*]

**M. Carrie :** Nous avons effectivement consulté ce rapport et celui qui a suivi, que vous avez déposé en 2005. S'agissant des REEE, un examen approfondi a révélé que toute exemption accordée au titre du programme ouvrirait la porte aux abus. La première raison est que le débiteur pourrait n'importe quand avoir accès au capital ainsi constitué par lui, la seconde étant que l'utilisation faite par l'enfant du capital ainsi constitué ne serait pas limité exclusivement à des fins scolaires, et la troisième qu'un débiteur pourrait ouvrir plusieurs REEE. C'est pour ces trois raisons que nous n'avons pas donné suite.

**Le sénateur Moore :** Ne pourrait-on pas ajouter une date butoir afin de prévenir de tels abus? Si par exemple un entrepreneur consulte ses états financiers et s'aperçoit que ses affaires ne vont pas bien et que son entreprise risque de faire faillite, il pourrait décider d'investir de 20 000 $ à 50 000 $ dans l'entreprise pour l'éducation de son petit-fils. Ne pourrait-il pas y avoir une disposition visant à protéger les REEE tant que les dépôts ont été faits à des intervalles de 12 ou de 18 mois?

**M. Carrie :** On pourrait sans doute en débattre. J'aimerais vous dire que le projet de loi C-12 constitue plus ou moins une solution d'ordre technique.

**Senator Moore:** I know. We have been going around this subject since 2003.

**Mr. Carrie:** We are trying to fix what we have and implement it. Then, over the next few years, as my colleagues have said, we will review it. Perhaps we could look at the various excellent suggestions of senators in respect of policy. We need to understand that the bill as it stands is not ideal and we are trying to ensure that we have improved legislation. Bill C-12 is good proposed legislation. We would like to see if we can get this moving forward as quickly as possible.

**Senator Moore:** The existing statutes, which this amends, have a statutory legislative five-year review, which means that the two parent statutes will be reviewed next year. Is that right? I believe that the last one was in 2003 and we are heading into 2008 for the review of those two statutes, which is normally done by this committee. Is that the correct year?

**Mr. Charland:** It is correct but not entirely accurate.

**Senator Moore:** What does that mean?

**Mr. Charland:** The five-year review began in 2003, which led to the initial tabling and passing of chapter 47. Chapter 47 was never brought into force and, therefore, the new five-year cycle was never officially started. We want to move forward quickly by amending chapter 47 in order to fix it so that it can be brought into force, after which the five-year period will begin. It would not be accurate to think that the five-year period began in 2003.

**Senator Moore:** I thought the review of the two main statutes happened every five years regardless of the impact of interim legislation.

You are telling me that because the bill was not proclaimed, that the five-year period is still open, and indeed that it has not even begun. I did not understand that to be the law, but I might be wrong.

Assuming that I am partially correct; could the legislation dealing with the workers be looked at in step with the other main two statutes. I know it has a five-year review provision, but would it not make sense to review the three statutes at the same time?

[*Translation*]

**Mr. Blackburn:** Why are we now dealing with this legislation to protect workers and their wages in case the employer goes bankrupt? It all began with a unanimous decision by Parliament. All the political parties agreed that this had to be protected. Then, we looked for a way to protect the wages of the workers. We realized that this would involve amending two pieces of legislation; it would also involve the Department of Labour,

**Le sénateur Moore :** Je sais bien. Nous nous penchons sur ce sujet depuis 2003.

**M. Carrie :** Nous tentons d'amender la loi existante et de la mettre en œuvre. Ensuite, comme mes collègues l'ont dit, nous effectuerons un examen au fil des prochaines années. C'est à ce moment-là qu'on pourrait peut-être considérer les diverses suggestions des sénateurs en matière de politique, suggestions qui sont excellentes, par ailleurs. Nous devons comprendre que le projet de loi, tel qu'il existe actuellement, ne représente pas la solution idéale et nous visons à améliorer la loi. Le projet de loi C-12 est un bon projet de loi. Nous aimerions le faire adopter aussi rapidement que possible.

**Le sénateur Moore :** Les lois actuelles qui seront modifiées par le projet de loi font l'objet d'un examen législatif tous les cinq ans, ce qui veut dire que les deux lois connexes feront l'objet d'un examen l'année prochaine. Ai-je bien raison? Je crois que le dernier examen remonte à 2003 et qu'en 2008 nous procéderons à l'examen des deux lois, travail qui est fait normalement par notre comité. Est-ce que j'ai raison en ce qui concerne 2008?

**M. Charland :** Ce que vous dites est correct, mais ce n'est pas tout à fait exact.

**Le sénateur Moore :** Que voulez-vous dire?

**M. Charland :** L'examen quinquennal a commencé en 2003, ce qui a mené au dépôt du projet de loi et à l'adoption du chapitre 47. Le chapitre 47 n'est jamais entré en vigueur et, par conséquent, le nouveau cycle quinquennal n'a jamais été officiellement mis en branle. Nous voulons agir aussi rapidement que possible en modifiant le chapitre 47 pour y apporter des corrections nécessaires afin qu'il puisse entrer en vigueur, et c'est à ce moment-là que la période quinquennale commencera. Il serait inexact de dire que la période quinquennale a commencé en 2003.

**Le sénateur Moore :** Je croyais que l'examen des deux lois principales avait lieu tous les cinq ans, indépendamment de l'incidence de la législation intérimaire.

Vous me dites que puisque le projet de loi n'a pas été promulgué, la période quinquennale n'a pas encore commencé. Je ne croyais pas que c'était le cas, mais j'avais tort.

Admettons que j'ai raison en partie. Serait-il possible d'examiner la loi visant les travailleurs ainsi que les deux autres lois principales? Je sais que la loi prévoit un examen quinquennal, mais ne serait-il pas plus logique d'examiner ces trois lois en même temps?

[*Français*]

**M. Blackburn :** Pourquoi en arrive-t-on aujourd'hui à cette loi visant la protection des travailleurs et de leur salaire face à une faillite de l'entreprise qui les emploie? Le point de départ a été la décision unanime du Parlement. Tous les partis politiques ont dit qu'il fallait protéger cela. On s'est alors demandé comment faire pour protéger le salaire de ces travailleurs. Nous nous sommes rendu compte que, pour le faire, cela impliquait des changements

as well as the Bankruptcy and Insolvency Act and the Companies' Creditors Arrangement Act. We had to take that into account.

However, if we want to make a full review of the two acts that I just mentioned, to find out if anything else should be changed or improved or brought up to date to 2007 or 2008, and if we also want to review the Companies' Creditors Arrangement Act, we will never see the end of it.

If we did that, we would no longer be able to produce legislation for protecting workers, because we would be looking at an extremely long process.

We should, rather, do what Parliament has asked for, and we must protect the workers.

[*English*]

**Senator Moore:** Mr. Blackburn, you are suggesting that we perform the statute reviews separately.

[*Translation*]

**Mr. Blackburn:** That is exactly it.

[*English*]

**Senator Moore:** Mr. Carrie in your brief you write, "Again, as a matter of fairness, debts that existed before an insolvency filing will not be entitled to jump ahead of other creditors." Is the reference to secured debts?

**Mr. Carrie:** Yes.

**Senator Moore:** What debts could there be after, unless something was incurred as an ongoing concern?

**Mr. Dooley:** This portion of presentation was in respect of interim financing such that a lender agrees to provide financing to a company undergoing a restructuring.

**The Chair:** Is that referred to as debtor-in-possession, or DIP, financing?

**Mr. Dooley:** Yes, it is. The proposed legislation says that if you provide DIP financing, the special security granted by the court will only apply to the DIP funding. For example, where the lender was owed $100 million prior to the company filing for insolvency, that lender provided more financing after the insolvency. They included $100 million in that special charge to cover the pre-existing debt. The existing lender had been ranked below the other creditors but by pulling that $100 million up to the top of the pack, it secured the lender first place over other creditors who had a higher priority in the bankruptcy. The practice, called "boot-strapping," is not well received. Unfortunately, it has happened before and we want to ensure that it does not happen again because it is simply unfair to the existing creditors.

dans deux lois; le ministère du Travail est impliqué, ainsi que la Loi sur les faillites et l'insolvabilité et la Loi sur les arrangements avec les créanciers des compagnies. Il fallait tenir compte de cela.

Mais si on veut tout revoir au niveau des deux lois que je viens de citer, pour savoir s'il y a autre chose qu'on devrait y changer pour l'améliorer et la rendre plus conforme à la réalité de 2007 ou 2008, et qu'on veut également revoir la Loi sur les arrangements avec les créanciers, c'est là que nous ne pourrons plus nous en sortir.

Dans ce cas de figure, nous ne serons plus en mesure de mettre en place notre loi pour protéger les travailleurs, parce que vous voulez embarquer dans un processus qui sera très long.

Nous disons plutôt que nous devrions faire ce que le Parlement a voulu et déterminer qui nous voulons protéger; ce sont les travailleurs.

[*Traduction*]

**Le sénateur Moore :** Monsieur Blackburn, vous proposez que nous effectuions des examens législatifs distincts.

[*Français*]

**M. Blackburn :** C'est exactement cela.

[*Traduction*]

**Le sénateur Moore :** Monsieur Carrie, vous avez indiqué dans votre mémoire ce qui suit : « Encore une fois, par souci d'équité, les dettes qui existaient avant la proposition d'insolvabilité n'auront pas préséance sur celles des autres créanciers. » Faites-vous référence aux dettes garanties?

**M. Carrie :** Oui.

**Le sénateur Moore :** Quel genre de dettes pourrait-il y avoir après la déclaration, à moins que ce ne soit une dette contractée par une entreprise toujours en exploitation?

**M. Dooley :** Cette partie de l'exposé portait sur le financement provisoire, par exemple, lorsqu'un prêteur accepte d'accorder un financement à une société en cours de restructuration.

**Le président :** Est-ce que c'est ce qu'on appelle le financement du débiteur-exploitant, le financement DIP?

**M. Dooley :** C'est exact. Le projet de loi précise que si vous accordez un financement DIP, la garantie spéciale accordée par le tribunal ne s'appliquera qu'à ce financement. Par exemple, si le débiteur devait 100 millions de dollars au prêteur avant la déclaration d'insolvabilité, ce prêteur a décidé d'accorder un financement supplémentaire après l'insolvabilité. Ils incluent les 100 millions de dollars dans cette charge spéciale qui couvre la dette déjà encourue. Le prêteur venait après les autres créanciers mais en injectant cette somme de 100 millions de dollars, il a amélioré sa position pour avoir la priorité par rapport aux autres créanciers. Cette pratique qu'on appelle le « boot-strapping », n'est pas vue d'un bon œil. Malheureusement, cela s'est déjà produit et nous voulons nous assurer qu'on n'aura pas recours à cette pratique à nouveau parce que c'est simplement injuste à l'égard des autres créanciers.

**Senator Moore:** Therefore, the lender to the insolvent firm would bring money he was owed by the company and add it to the outstanding debt.

**Mr. Dooley:** Yes.

**Senator Moore:** Therefore, the lender would be ahead of all other creditors. Does the court allow that practice?

**Mr. Dooley:** Yes, it has happened. For example, they lend $100 million afterward but their charge would be for the full $200 million. Unfortunately, it has happened and, as I say, we would not like to see it happen again.

**Senator Moore:** Bill C-12 makes it clear that a trustee or receiver should not be personally responsible for existing obligations. To ensure that workers are not left without recourse, Bill C-12 also makes it clear that their claims continue against the new purchaser. Therefore, the trustee is not responsible for obligations that he or she finds when they take over the insolvent company. The ongoing concern is hoping to put it together and sell it. If they take on debt to do that, are they responsible for that new debt?

**Mr. Carrie:** Basically, yes they are responsible.

**Senator Moore:** Are they personally responsible?

**The Chair:** Usually it is a corporate responsibility.

**Mr. Carrie:** Yes, they are usually corporations.

**Senator Moore:** That is quite a risk.

**Mr. Carrie:** They seemed to be okay with that, though, in the consultation process.

**The Chair:** It is in the context of debt restructuring. They cannot continue the business and the judge gives them 30 days to get their act together. If they do not accept the plan, they go to the tank. People who are putting up the money have a great deal of leverage.

**Senator Moore:** They are personally responsible for debts incurred on behalf of the ongoing charge.

**Mr. Carrie:** They seem to be okay with that. The idea is to clarify that because recent court decisions put the trustees at risk of personal liability for debts. Therefore, we wanted to clarify that.

**Senator Moore:** My last question is with regard to restructuring the rights of equity holders. It is possible for equity holders to get paid when other creditors do not. This is a problem because equity holders should not have greater risks in a restructuring of debt than they would have in a bankruptcy.

**Le sénateur Moore :** Ainsi, le prêteur qui offre de l'argent à la compagnie insolvable prend en fait l'argent qu'on lui devait déjà pour l'ajouter à la dette active.

**M. Dooley :** C'est exact.

**Le sénateur Moore :** Ainsi, ce prêteur aurait priorité sur tous les autres créanciers. Est-ce que les tribunaux autorisent cette pratique?

**M. Dooley :** Oui, ça c'est produit. Par exemple, le prêteur injecte 100 millions de dollars après la déclaration d'insolvabilité mais la charge toucherait le plein montant, soit 200 millions de dollars. Malheureusement, cela s'est déjà produit et, comme je l'ai signalé, nous voudrions éviter que ce genre de choses ne se produise à nouveau.

**Le sénateur Moore :** Le projet de loi C-12 précise qu'un syndic ou un séquestre ne devrait pas personnellement être responsable des obligations existantes. Afin de garantir que les travailleurs ne se trouveront pas sans recours, le projet de loi C-12 précise que leurs réclamations demeureront valables même jusqu'à ce qu'il y ait un nouvel acheteur. Ainsi, le syndic n'est pas responsable des obligations qu'il découvre lorsqu'il assume la responsabilité de la compagnie insolvable. La priorité c'est de réorganiser l'entreprise et de la vendre. S'ils assument des dettes pour y parvenir, sont-ils responsables de la nouvelle dette?

**M. Carrie :** Oui.

**Le sénateur Moore :** Sont-ils personnellement responsables?

**Le président :** Il s'agit habituellement d'une responsabilité corporative.

**M. Carrie :** Oui, il s'agit habituellement de sociétés.

**Le sénateur Moore :** Mais il s'agit d'un risque important.

**M. Carrie :** Ils semblent l'accepter, comme cela a été reflété dans le processus de consultation.

**Le président :** Tout ça est fait dans le contexte de la restructuration de la dette. Ils ne peuvent pas laisser l'entreprise fonctionner et le juge leur donne 30 jours pour s'organiser. S'ils n'acceptent pas le plan, c'est fini. Les gens qui offrent le financement ont beaucoup de pouvoir.

**Le sénateur Moore :** Ils sont personnellement responsables des dettes encourues au titre de la charge.

**M. Carrie :** Ils semblent accepter ce fait. Le but est d'apporter des précisions parce que des décisions rendues récemment par les tribunaux placent les syndics dans une situation précaire car ils pourraient devenir responsables personnellement des dettes. C'est pourquoi nous voulons apporter la précision.

**Le sénateur Moore :** Ma dernière question porte sur la restructuration des droits des détenteurs d'actions. Ces derniers peuvent être remboursés alors qu'il est impossible pour certains créanciers d'obtenir un remboursement. Cela crée un problème parce que les détenteurs d'actions ne devraient pas assumer des risques plus importants lors de la restructuration d'une dette que ce ne serait le cas lors d'une faillite.

Do secured creditors, such as preferred shareholders, lose that preference? Normally, they remain in place and they receive their dividends when a restructured company is able to payout.

**Mr. Dooley:** Under corporate law and insolvency law, the payment of dividends when the company is insolvent is prohibited. If the shares continue, in effect, after, then they would have their preferred claim as well. That would depend upon the plan and what it says about how those shares are to be dealt with — whether they are to be wiped out, as has happened in some cases, or whether they are to continue.

**The Chair:** Very good question, Senator Moore. Thank you for that.

**Senator Peterson:** I have a question regarding the Wage Earner Protection Program. In the event of insolvency, does Revenue Canada have first dibs on the left over funds?

**Munir A. Sheikh, Deputy Minister of Labour, Human Resources and Social Development Canada:** The government has the first claim to monies owed to government by a firm that becomes insolvent. For example, if the business held employment insurance contributions or Canada Pension Plan contributions, according to the priority in the Bankruptcy and Insolvency Act, the government has the first claim on it. That has not changed. The changes to the Wage Earner Protection Program and the Bankruptcy and Insolvency Act have not been effected in any way.

[*Translation*]

**Mr. Blackburn:** I have a point of clarification. Regarding the protection of workers' wages, wage claims are only subordinate to the rights of unpaid suppliers to repossess their merchandise, under certain conditions, and to claims related to deemed trusts such as undisbursed payroll deductions, including employment insurance and Canada Pension Plan contributions.

[*English*]

**Senator Peterson:** In the presentation, we said that the amounts are usually very small, but they are very important to the worker who is not being paid. Really, what we are saying is it is more important to the government than the worker — that they should get it first, is that correct? If they are not collecting their unemployment insurance and tax, they must be aware of that non-payment. Why would the wage earner have to take the hit on that?

[*Translation*]

**Mr. Blackburn:** I must clarify this point. The worker is protected; the government will pay, with our $37.5 million fund. If there is a bankruptcy, we will pay the employee's wages

Les créanciers garantis, tels les actionnaires privilégiés, perdent-ils ce privilège? Dans les circonstances normales, ils reçoivent leurs dividendes lorsqu'une société restructurée est en mesure d'en payer.

**M. Dooley :** Aux termes de la Loi sur la faillite et l'insolvabilité, le versement de dividendes est interdit lorsqu'une entreprise est insolvable. Si les actions continuent à exister, en fait, après la restructuration, les actionnaires auront une réclamation privilégiée. Cela dépend du plan de restructuration et les traitements prévus des actionnaires — si ces actions vont simplement disparaître, comme cela a été le cas dans certaines circonstances, ou si elles continueront à exister.

**Le président :** C'est une excellente question, sénateur Moore, je vous en remercie.

**Le sénateur Peterson :** J'aimerais poser une question sur le Programme de protection des salariés. S'il y a insolvabilité, est-ce que Revenu Canada a la priorité par rapport aux autres créanciers?

**Munir A. Sheikh, sous-ministre du Travail, Ressources humaines et Développement social Canada :** Le gouvernement a une réclamation prioritaire pour l'argent qu'une compagnie lui doit lorsqu'elle devient insolvable. Par exemple, si l'entreprise devait des cotisations d'assurance-emploi ou de pension de retraite, conformément à la priorité établie dans la Loi sur la faillite et l'insolvabilité, le gouvernement a la priorité. Cela n'a pas changé. Les modifications apportées au Programme de protection des salariés et à la Loi sur la faillite et l'insolvabilité n'ont rien changé à cet égard.

[*Français*]

**M. Blackburn :** J'aimerais apporter une clarification sur ce sujet. Au niveau de la protection du salaire des travailleurs, les créances salariales sont subordonnées uniquement aux droits des fournisseurs non payés de reprendre possession de leurs marchandises, à certaines conditions, et aux créances des fiducies répétées comme les retenues à la source non versées, c'est-à-dire les cotisations à l'assurance-chômage et au Régime de pensions du Canada.

[*Traduction*]

**Le sénateur Peterson :** Dans l'exposé, vous avez dit que ces montants étaient habituellement très peu élevés, mais ils sont très importants pour le travailleur qui n'est pas payé. Ce que vous dites en fait c'est qu'il est plus important que le gouvernement soit remboursé que le travailleur — parce que vous dites en fait que c'est le gouvernement qui devrait avoir la priorité, ai-je bien saisi? Si le gouvernement ne perçoit pas ses impôts, ses taxes ou les cotisations au titre du programme d'assurance-emploi, il doit être clairement au courant du fait qu'on lui doit de l'argent. Pourquoi le salarié devrait-il être pénalisé?

[*Français*]

**M. Blackburn :** Je dois apporter une précision, ici. Le travailleur est protégé; c'est le gouvernement qui le payera, avec notre fonds de 37,5 millions de dollars. Lorsqu'il y a une

to cover him up to a maximum of $3,000, or four weeks. Afterward, the government will seek payment from the trustee. However, the worker's salary is protected up to a maximum of $3,000.

[*English*]

**The Chair:** That is without having to take legal proceedings. That is why it appears the government has a preferred interest, but it is the reverse. They pay first again.

**Senator Peterson:** Thank you for the clarification.

[*Translation*]

**Senator Ringuette:** My questions are in the same vein. Earlier, Mr. Minister, you said that the Employee Wage Protection Program would cost between $37 million and $50 million.

**Mr. Blackburn:** Yes.

**Senator Ringuette:** Could you tell me how much of these estimated costs will be spent on administering the program?

**Mr. Blackburn:** From the $37.5 million, we estimate $28.5 million will serve to reimburse workers' wages when companies go bankrupt, $3.5 million will serve to manage the program, and $2.5 million will serve to reimburse the sums left unpaid by trustees and receiver agents.

**Senator Ringuette:** Will the program be managed centrally from your office?

**Mr. Blackburn:** The management will be done by Service Canada because they are close to the citizens who receive federal government services. When a company goes bankrupt, a worker can get in touch with Service Canada and the process will be set in motion so that people get paid promptly.

We estimate that about 10,000 or 20,000 workers will receive such payments every year. Of course, there could be a larger or smaller number of bankruptcies in any given year, but these are our current estimations.

**The Chair:** Senator Biron, do you have another question?

**Senator Biron:** No.

[*English*]

**Senator Moore:** I have another question. Minister, in your remarks, you said that chapter 47 will reduce the discharge prohibition period from 10 years to seven years; in the case of hardship, it would be reduced to five years.

When our committee was doing the review of these statutes in 2003, banks and the credit rating agencies all said that five years was an appropriate period. Students, of course, wanted zero, which is understandable but not realistic. Your bill says seven years.

faillite, on payera le salaire de l'employé afin qu'il soit couvert jusqu'à un maximum de 3 000 $, quatre semaines. Ensuite, le gouvernement interviendra au niveau du syndic pour se faire payer. Mais le salaire du travailleur, lui, est protégé jusqu'à concurrence de 3 000 $.

[*Traduction*]

**Le président :** Sans avoir à intenter des poursuites. C'est pourquoi on semble croire que le gouvernement a la priorité mais en fait c'est le contraire. Encore une fois, il paie en premier.

**Le sénateur Peterson :** Je vous remercie de cette précision.

[*Français*]

**Le sénateur Ringuette :** Mes questions sont dans la même veine. Tout à l'heure, monsieur le ministre, vous avez indiqué que le Programme de protection des salariés coûtera de 37 à 50 millions de dollars.

**M. Blackburn :** Oui.

**Le sénateur Ringuette :** De ces estimations de coûts, pouvez-vous m'indiquer quels seront les coûts d'administration du programme?

**M. Blackburn :** Sur les 37,5 millions, on estime qu'il y aura 28,5 millions de dollars qui serviront à rembourser les salaires des travailleurs suite aux faillites dans leur entreprise, 3,5 millions iront à l'administration du programme, et 2,5 millions de dollars rembourseront les frais non payés par les syndics et les agents du séquestre.

**Le sénateur Ringuette :** Est-ce votre bureau qui administrera, de façon centrale, le programme?

**M. Blackburn :** C'est Service Canada, qui est près des citoyens, en termes d'offres de services du gouvernement fédéral, qui s'occupera de la gestion. Lorsque l'entreprise fait faillite, le travailleur contactera Service Canada et tout le processus s'enclenchera afin que les gens soient payés rapidement.

On estime entre 10 000 et 20 000 par année les travailleurs qui, en principe, recevront ce paiement. Bien sûr, il peut y avoir plus ou moins de faillites une année, mais ce sont les estimations actuelles.

**Le président :** Sénateur Biron, vous avez une autre question?

**Le sénateur Biron :** Non.

[*Traduction*]

**Le sénateur Moore :** J'ai une autre question. Monsieur le ministre, vous avez signalé dans vos commentaires liminaires que le chapitre 47 permettra de ramener la période d'interdiction de libération de 10 à sept ans, et en cas de difficultés extrêmes, à cinq ans.

Lorsque notre comité a procédé à une étude de ces lois en 2003, les banques et les agences de notation ont dit que cinq ans serait la période appropriée. Les étudiants, évidemment, voulaient qu'on élimine cette période, ce qui est compréhensible mais peu réaliste. Le projet de loi propose sept ans.

How did you arrive at seven years? In view of all the input we had — and this was from a whole cross-section of people interested in this area, including the banks — they thought five years was an acceptable period of time. How did we arrive at seven?

**Mr. Carrie:** From our standpoint, where the numbers are depends on how you want to make the program viable and continue its viability so that it is ongoing. As for details on the decision of how the number was arrived at, I would ask Ms. Frith to provide that information.

**Ms. Frith:** The seven years is basically a representation of the debt management measures that have been put in place. Since 2004, student borrowers who go into bankruptcy are able to access interest relief and debt reduction in their payment. That period of time covers five years of interest relief with no interest payments, no payment on the principal. For the following three years, they would be entitled first to a reduction of $10,000, then a year later another $10,000 and another year later $6,000. That would reduce them by $26,000 overall, and that covers eight years. Therefore, seven years was considered to be very reasonable in terms of alignment with the current debt management measures.

**Senator Moore:** It is lined up with the program, is that correct?

**Ms. Frith:** Yes.

**Senator Meighen:** We have talked a lot about the Wage Earner Protection Program Act. I think the minister just said that a worker would receive a maximum of $3,000, covering four weeks of wages.

My understanding is that would cover about 97 per cent of wage earners. Was that an obvious break point? Did you arrive at it because over that, you are dealing with perhaps middle management that may earn a considerably higher salary and therefore did not need protection; or was it that the protection of 100 per cent of wage earners would have been substantially more expensive?

Second, where does that person rank who falls in that 3 per cent that is not covered? Do they rank as they would have without the Wage Earner Protection Program Act?

[*Translation*]

**Mr. Blackburn:** If we cover 97 per cent of the workers, and our objective is to protect as many people as possible, we think that it would amount to $3,000 for four weeks of wages, as the current average weekly wage is about $750. Beyond that, the claimant will still receive a total of $3,000.

**Senator Meighen:** Is that so?

Comment en êtes-vous arrivé à ce chiffre? Compte tenu de tous les commentaires que nous avons entendus — et nous avons entendu des représentants de tous les groupes s'intéressant à la question, y compris les banques — qui nous ont proposé cinq ans comme période acceptable, comment en êtes-vous à une période de sept ans?

**M. Carrie :** Nous jugeons qu'il fallait établir une période qui rendrait ce programme viable à long terme. Pour ce qui est de la façon dont nous en sommes venus à cette période, je demanderais à Mme Frith de vous fournir ces renseignements.

**Mme Frith :** La période de sept ans est compatible avec les mesures de gestion de la dette qui ont été adoptées. Depuis 2004, les étudiants qui empruntent et qui font faillite peuvent obtenir un allègement des intérêts et une réduction de leur paiement. Cette période est de cinq ans d'allègement des intérêts avec un paiement d'intérêt, aucun paiement sur le principal. Pendant les trois années suivantes, ces étudiants auront droit tout d'abord à une réduction de 10 000 $, puis un an plus tard, une autre réduction de 10 000 $ et un an plus tard une réduction de 6 000 $. Cela permettrait de réduire leur dette de 26 000 $, et ce sur une période de huit ans. Ainsi, on jugeait que sept ans est une période raisonnable, ce qui permet de garantir que cette période est compatible avec les mesures actuelles de gestion de la dette.

**Le sénateur Moore :** Alors tout ça est harmonisé avec le programme, est-ce exact?

**Mme Frith :** C'est exact.

**Le sénateur Meighen :** Nous avons beaucoup parlé de la Loi sur le programme de protection des salariés. Je crois que le ministre vient de dire qu'un salarié recevrait un montant maximum de 3 000 $, pour quatre semaines de salaire.

J'ai cru comprendre que cela toucherait environ 97 p. 100 des salariés. Comment en êtes-vous arrivé à ce moment? Est-ce parce que s'il s'agissait d'un montant plus élevé il s'agirait peut-être des cadres intermédiaires qui reçoivent donc un salaire considérablement plus élevé et n'avaient donc pas besoin de protection; s'agit-il plutôt que la protection de tous les salariés aurait coûté beaucoup plus cher?

De plus, dans quelle position se trouve la personne qui fait partie des 3 p. 100 qui ne sont pas protégées? Est-ce qu'elles se retrouvent dans la situation qui aurait été la leur si la Loi sur le programme de protection des salariés n'existait pas?

[*Français*]

**M. Blackburn :** Si on couvre 97 p. 100 des travailleurs — et c'est l'objectif : protéger le plus grand nombre de personnes possible —, on pense que jusqu'à concurrence de 3 000 $ ou quatre semaines de salaire, la moyenne actuelle tourne autour de 750 $ de gains par semaine. Au-delà de cela, la personne va quand même recevoir un montant de 3 000 $.

**Le sénateur Meighen :** Oui?

**Mr. Blackburn:** Of course. You are protected up to $3,000. However, if your income was much higher, you would still receive the basic $3,000. As for the rest, those who do not have it will have to rely on claims. According to the statistics, in previous years, 79 per cent of workers never received anything. Thus, there might be nothing left for him.

**Senator Meighen:** Is he still covered by the unpaid wages claims or is he considered on the same footing as an unpaid supplier? Is he still covered by the unpaid wages claims?

[*English*]

**Mr. Sheikh:** There are basically three categories of workers. Anyone who is eligible will get reimbursed up to $3,000. Someone may get $1,000 or $2,000, but the figure is up to $3,000. Nobody will be left out. However, obviously some people may not qualify immediately. For example, there is a provision that says if you are related to the owner of the business, you may have difficulty collecting your money; even those people can put a claim in to Service Canada and demonstrate that the claim is above board. They would be covered as a second group of people, but they would be part of the Wage Earner Protection Program. The third group of people includes people who have claims above $3,000 or, for some other reason, do not qualify. They are like any other creditors on the priority list. Wherever they fall, they fall. The third group does not receive preference.

**Senator Meighen:** Even though it is an unpaid salary, which under the present laws, as I understand it, has a certain preference, you will rank them along with any other unpaid creditor for the portion over 3,000.

**Mr. Sheikh:** As the priority list stands, they will stay where they are.

**Senator Meighen:** I am still not clear. Under the present act, if I am owed $10,000 in salary, do I not have a different rank from a trade creditor who is owed $10,000?

**Mr. Sheikh:** Of course. My colleagues from Industry Canada can explain the priority list. There is a list of priorities as to how the assets will be distributed. That has not changed. The only thing that has changed is that the government will pick up the tab for up to $3,000.

**Senator Meighen:** I get that, but you have not told me where the difference between $3,000 and what I am owed in salary of $10,000 ranks. Is it ranked as unpaid salary or just another unsecured credit?

**Mr. Carrie:** My understanding is that it would be ranked as another unsecured creditor. With the present situation, employees may get 13 cents per dollar when the time comes. I spoke earlier about having a balanced approach. Here, the government is

**M. Blackburn :** Mais oui. Vous êtes protégé jusqu'à 3 000 $. Mais si votre revenu était beaucoup plus élevé, vous recevez quand même le 3 000 $ de base. Pour le reste, celui qui ne l'a pas va tomber dans les créances. S'il fait partie des statistiques — dans les années antérieures, 79 p. 100 des travailleurs ne recevaient jamais rien —, alors il risque de ne rien avoir dans la balance.

**Le sénateur Meighen :** Est-ce qu'il fait partie des créances représentant des salaires non payés ou il fait partie des créances tout comme un vendeur de marchandises? Est-ce qu'il reste parmi les salariés non payés?

[*Traduction*]

**M. Sheikh :** Il y a en fait trois catégories de travailleurs. Tous ceux qui sont admissibles recevront un remboursement maximal de 3 000 $. Certains recevront peut-être 1 000 $ ou 2 000 $, mais le montant maximal prévu est 3 000 $. Personne ne sera écarté. Cependant, clairement, certaines personnes ne pourront pas être admissibles immédiatement. Par exemple, une disposition précise que si vous êtes parent du propriétaire de l'entreprise, il vous sera peut-être difficile d'obtenir votre argent; cependant, même ces personnes peuvent présenter une réclamation à Service Canada et démontrer que cette réclamation est justifiée. Dans ces circonstances, ces personnes seraient protégées et feraient partie du deuxième groupe d'intervenants, et seraient protégées dans le cadre du programme de protection des salariés. Le troisième groupe de personnes inclut celles qui ont des réclamations dépassant 3 000 $ ou, celles qui pour une raison quelconque ne sont pas admissibles. Elles seront traitées de la même façon que les créanciers sur la liste de priorité. Le troisième groupe ne reçoit aucun traitement privilégié.

**Le sénateur Meighen :** Même s'il y a un salaire non payé, ce qui aux termes de la loi actuelle, si j'ai bien saisi, accorde une certaine priorité, vous les classerez de la même façon que tous les autres créanciers non payés pour tout montant dépassant 3 000 $.

**M. Sheikh :** Oui, en fonction de la liste des priorités.

**Le sénateur Meighen :** Je ne comprends toujours pas. Aux termes de la loi actuelle, si on me doit 10 000 $ en salaire non payé, n'ai-je pas une priorité supérieure à celle du créancier commercial à qui l'on doit 10 000 $?

**M. Sheikh :** Évidemment. Mes collègues d'Industrie Canada peuvent vous expliquer la liste de priorités. Il existe une liste de priorités en fonction de laquelle les biens sont distribués. Cela n'a pas changé. La seule chose qui a changé est que le gouvernement assumera la responsabilité d'un montant ne dépassant pas 3 000 $.

**Le sénateur Meighen :** Je comprends, mais vous ne m'avez pas expliqué quelle est la différence entre le 3 000 $ et ce qu'on me doit, soit 10 000 $. Est-ce que cette différence figure comme salaire non payé ou simplement une créance non garantie?

**M. Carrie :** Si j'ai bien compris cela ferait partie des autres créances non garanties. Dans les circonstances actuelles, les employés reçoivent peut-être 13 sous par dollar lorsque le moment vient de les rembourser. J'ai dit un peu plus tôt qu'on voulait une

taking the hit up front and putting in the $3,000 so the employee is paid up front. The government will only be able to recover a maximum of $2,000 of that later on. The employee who is owed above the $3,000 will go as unsecured. It will go onto the list, and they will have to wait for that money. They may end up 13 cents on the dollar for that. Everyone is taking a little bit of a hit here, and that is the balance.

**Senator Meighen:** I believe this legislation is a great improvement.

**Mr. Carrie:** Yes, it is.

**Senator Meighen:** However, under present legislation, if I am owed $10,000 for salary, do I not rank ahead of a trade creditor? If so, you are telling me now that the proportion above $3,000 under the proposed legislation will fall a rank. It will no longer be considered unpaid salary but will rank just like any trade creditor.

**Mr. Carrie:** That is a good question. Mr. Dooley will give the technical answer.

**The Chair:** Are the directors on the hook under the Business Corporations Act to pay that?

**Mr. Dooley:** While you are correct that a wage claim does have what is called a preferred claim, which ranks above unsecured, it is limited to $2,000. We have simply moved the preferred claim to above the secured so they are now called a super priority. They have not lost anything. They are moving up a step.

**Senator Meighen:** For $1,000?

**Mr. Dooley:** You get $3,000 from the WEPP, but the super priority is only $2,000. The recovery for the WEPP will only be up to $2,000, which is the amount of the current preferred claim. For the extra $8,000 wage claim owed in the example, you would have been unsecured previous to this act anyway. It is an improvement.

**Senator Meighen:** Thank you very much.

[*Translation*]

**Senator Meighen:** If, theoretically, we adopted the technical amendments in this bill today, how much time would it take before workers could benefit from this legislation? Do we not have to draft regulations before we can apply it?

**Mr. Blackburn:** You are right, we have to go through the entire process. We think that it could take about six months. Implementing regulations always takes time. Even I, as a government minister, was surprised to see how much time it always takes. But that is how the system works and we have

approche équilibrée. Le gouvernement accepte la responsabilité pour 3 000 $ de sorte que l'employé sera payé. Le gouvernement ne pourra recevoir qu'un maximum de 2 000 $ de ce montant plus tard. L'employé à qui l'on doit plus de 3 000 $ sera un créancier non garanti. Il sera ajouté à la liste et devra attendre. Il pourra se retrouver avec simplement 13 cents par dollar qu'on lui devait. Tout le monde en fait paie en quelque sorte pour les pots cassés, et c'est justement l'équilibre qu'on voulait assurer.

**Le sénateur Meighen :** Je crois que cette mesure législative représente des améliorations importantes.

**M. Carrie :** C'est vrai.

**Le sénateur Meighen :** Cependant, aux termes de la loi actuelle, si on me doit 10 000 $ en salaire non payé, n'ai-je pas priorité par rapport à un fournisseur? Dans l'affirmative, vous me dites que maintenant tout montant dépassant 3 000 $ fera partie des créances non garanties. Il ne s'agira plus donc dans ces circonstances de salaire non payé mais quelque chose qui aura la même priorité que les réclamations d'un fournisseur.

**M. Carrie :** C'est une bonne question. M. Dooley vous donnera les détails techniques.

**Le président :** Est-ce que les membres du conseil d'administration doivent, conformément à la Loi sur les sociétés par action, payer ces montants?

**M. Dooley :** Vous avez raison de dire qu'une réclamation pour salaire est en fait une réclamation prioritaire qui a priorité par rapport aux créances non garanties, limitées à 2 000 $. Nous avons simplement accordé une plus grande priorité aux créances prioritaires qu'aux créances garanties et on appelle cela maintenant la super priorité. Ces créanciers n'ont rien perdu. En fait, leur position par rapport aux autres créanciers est améliorée.

**Le sénateur Meighen :** Pour un montant de 1 000 $?

**M. Dooley :** Vous recevez 3 000 $ du programme de protection des salariés, mais la super priorité ne représente que 2 000 $. Le montant récupéré par l'entremise du programme ne s'élèvera qu'à un montant ne dépassant pas 2 000 $, qui est le montant prévu actuellement pour les réclamations prioritaires. Pour un montant supplémentaire de 8 000 $ pour les salaires non payés, pour reprendre l'exemple, vous auriez été dans la position d'un créancier non garanti de toute façon avant l'adoption de la loi. Il s'agit donc d'une amélioration.

**Le sénateur Meighen :** Merci beaucoup.

[*Français*]

**Le sénateur Meighen :** Si on adoptait aujourd'hui, par exemple, en théorie, les amendements techniques proposés par ce projet de loi, combien de temps cela prendrait-il avant que les travailleurs bénéficient de ce projet de loi? N'est-il pas vrai que, avant d'entrer en vigueur, cela prendrait la rédaction des règlements?

**M. Blackburn :** Vous avez raison, il faut mettre en branle tout le processus. On estime que cela peut prendre à peu près six mois. Quand on met en place la réglementation, c'est toujours ainsi. Ce fut une surprise même pour moi, comme ministre, de voir combien tout cela prend toujours du temps. Mais c'est le système

to go through the entire process, which involves the participation of Service Canada. As of today, we expect it to take about six months.

*[English]*

**The Chair:** The witnesses agreed to be here until one o'clock. I wonder if we have reached a point where we could thank the witnesses for their attendance but ask them if they would have their officials monitor our hearings on this bill and make themselves available to come back, if necessary, to deal with this issue of possible other amendments. As you know the process, it is conceivable we will hear evidence that will drive us to say we cannot report this bill back unless there is some accommodation for whatever it is that comes out in the evidence.

If I understood the discussion earlier, there is a possibility that we could obtain an undertaking from both ministers that, in consideration of us not reporting the bill with amendments, they will ensure the department comes forward not in five years but as soon as possible. There is no guarantee, even though we are conscious there is the possibility at any moment in a minority government that there could be an election and there is a need for this bill. We are in this Catch-22. We want to do our job properly. Given the circumstances, unfortunate as they may be, all this time has passed. We would like to get the bill through, but we want to ensure it is either ready for prime time, and if not, that we have a process in place to fix it.

*[Translation]*

**Mr. Blackburn:** Ladies and gentlemen of the committee, you are recognized as experts. You see that this is a complex problem. We have to deal with two departments. On the one hand, we have the Bankruptcy and Insolvency Act, and on the other hand, the Companies' Creditors Arrangement Act; and then there is the Department of Labour. I know that you would like to make many amendments to the two acts that I just mentioned and that involve Industry Canada, because things have changed.

However, we want to protect workers as promptly as possible, those who work for companies that go bankrupt, and we want to protect their family income because it is important.

This is why we tried to be as flexible as we could to accommodate the will of Parliament. If you want more clarifications from us, we will, of course, be available. And if we do not do all the things that you would want us to do, in your wisdom, in the forthcoming legislation, if you think that we could act more quickly to protect our workers, we would be ready to hear your suggestions when you come back to the House of Commons.

**The Chair:** Mr. Minister, you have understood me correctly; thank you very much.

qui est comme cela et il faut mettre en place le processus, qui comprend l'implication de Service Canada. À ce jour, on prévoit une période de six mois environ.

*[Traduction]*

**Le président :** Les témoins ont accepté d'être des nôtres jusqu'à 13 heures. Je ne sais pas si nous devrions maintenant remercier les témoins d'être venus nous rencontrer mais leur demander s'il serait possible que leurs fonctionnaires suivent de près nos audiences sur ce projet de loi et soient prêts à venir nous rencontrer à nouveau si c'était nécessaire, si nous avions des questions ou des amendements supplémentaires. Vous connaissez la façon dont les choses se font ici, et il est possible que nous entendrons des témoins qui nous pousseront à dire que nous ne pouvons pas faire rapport de ce projet de loi à moins que des amendements soient apportés suite à ce que nous aurons entendu.

Si j'ai bien compris ce qui a été dit un peu plus tôt, il est possible que les deux ministres s'engagent, si nous décidions de faire rapport du projet de loi sans modification, à assurer que le ministère viendra présenter un rapport non dans cinq ans mais le plus tôt possible. Il n'y a pas de garantie, même nous savons que puisque nous avons un gouvernement minoritaire des élections pourraient avoir lieu n'importe quand et que ce projet de loi s'impose. Nous nous trouvons en quelque sorte entre l'arbre et l'écorce. Nous voulons faire notre travail comme il faut. Compte tenu des circonstances, aussi regrettables qu'elles soient, le temps a filé. Nous voudrions adopter le projet de loi, mais nous voulons nous assurer qu'il est un document approprié ou dans la négative, qu'il existe un processus qui nous permettra de combler les lacunes.

*[Français]*

**M. Blackburn :** Mesdames et messieurs les membres du comité, vous êtes reconnus comme un comité d'experts. Vous voyez la complexité, on touche à deux ministères; on a, d'une part, la Loi sur la faillite et l'insolvabilité, d'autre part, la Loi sur les arrangements avec les créanciers; et il y a le ministère du Travail. Je sais que vous voudriez apporter beaucoup de changements aux deux lois que j'ai citées plus tôt et qui relèvent d'Industrie Canada, car il y a une nouvelle réalité.

Toutefois, nous sommes dans une situation où nous voulons protéger le plus tôt possible le travailleur, celui qui travaille dans une entreprise qui a fait faillite, et on veut protéger le salaire de sa famille parce que c'est important.

C'est la raison pour laquelle nous avons essayé d'être le plus flexible possible pour arriver à tenir compte de la volonté des parlementaires. Si vous voulez davantage de clarifications de notre part, nous allons, bien sûr, nous rendre disponibles. Et si, dans votre sagesse, même si on ne touche pas à tout ce que vous souhaiteriez, dans la loi qui va venir ultérieurement, vous jugez qu'on peut aller plus rapidement pour faire en sorte de protéger nos travailleurs, nous serons près à vous entendre en ce sens lorsque que vous nous reviendrez à la Chambre des communes.

**Le président :** Monsieur le ministre, vous m'avez très bien compris; merci beaucoup.

[*English*]

**Mr. Carrie:** We realize you are working with us. It is important for Canadians that we get Bill C-12 through. It is good legislation. Whatever we can do to help your job go more smoothly, I am sure we will be able to make those resources available to you.

**The Chair:** Will your officials be monitoring our hearings as they progress in the next two weeks?

**Mr. Carrie:** Absolutely.

**The Chair:** On behalf of all members on this committee, we thank all of you.

The committee adjourned.

[*Traduction*]

**M. Carrie :** Je sais que vous collaborez avec nous. Il importe pour les Canadiens que nous fassions adopter le projet de loi C-12. Il s'agit d'une bonne mesure législative. Si nous pouvons vous aider et faciliter vos travaux, je suis convaincu que nous pourrons vous offrir les ressources nécessaires.

**Le président :** Est-ce que vos fonctionnaires suivront nos audiences au cours des deux prochaines semaines?

**M. Carrie :** Certainement.

**Le président :** Au nom de tous les sénateurs, je tiens à vous remercier d'être venus nous rencontrer.

La séance est levée.

*Human Resources and Social Development Canada:*

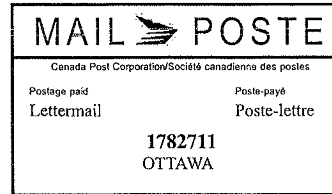
Rosaline Frith, Director General, Canada Student Loans Program;

John Hemingway, Program Analyst, Canada Student Loans Program.

*Ressources humaines et Développement social Canada :*

Rosaline Frith, directrice générale, Programme canadien de prêts aux étudiants;

John Hemingway, analyste de programme, Programme canadien de prêts aux étudiants.

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APPEARING

**Thursday, November 29, 2007**

The Honourable Jean-Pierre Blackburn, P.C., M.P., Minister of Labour;

Colin Carrie, M.P., Parliamentary Secretary to the Minister of Industry.

WITNESSES

**Thursday, November 29, 2007**

*Labour Program, Human Resources and Social Development Canada:*

Munir A. Sheikh, Deputy Minister of Labour;

Sylvie Heartfield, Chief, Policy Development.

*Industry Canada:*

Roger Charland, Senior Director, Corporate and Insolvency Law Policy and Internal Trade;

Matthew Dooley, Senior Project Leader, Corporate and Insolvency Law Policy and International Trade.

(*Continued on previous page*)

COMPARAISSENT

**Le jeudi 29 novembre 2007**

L'honorable Jean-Pierre Blackburn, C.P., député, ministre du Travail;

Colin Carrie, député, secrétaire parlementaire du ministre de l'Industrie.

TÉMOINS

**Le jeudi 29 novembre 2007**

*Programme du travail, Ressources humaines et Développement social Canada :*

Munir A. Sheikh, sous-ministre du Travail;

Sylvie Heartfield, chef en matière de politiques.

*Industrie Canada :*

Roger Charland, directeur principal, Politique du droit corporatif, de l'insolvabilité et du commerce intérieur;

Matthew Dooley, chef principal de projet, Politique du droit corporatif, de l'insolvabilité et du commerce intérieur.

(*Suite à la page précédente*)

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# TAB 19

# CANADIAN BANKRUPTCY AND INSOLVENCY LAW

## BILL C-55, STATUTE C.47 AND BEYOND

edited by

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and

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

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

## V. COURT-APPOINTED OFFICERS: INTERIM RECEIVERS

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

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

## VI. EQUITY INTEREST PROVISIONS

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

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

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

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

51 *Ibid.*

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

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

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

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

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

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

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

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

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

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

Furthermore, aside from damages or rescission claims, Statute c.47 makes no provision for plans to bind members of an equity class without their approval or without the need for consideration to be provided to the members of the equity class. Nor does it provide that equity claims may be extinguished. The net result is that equity claims may have an entitlement to participate *pro rata* in distributions with unsecured creditors generally in CCAA cases and an incentive to participate in the restructuring at all stages disproportionate to their typical economic interest as equity holders.

Bill C-62 makes the following further changes and addresses many, but not all, of the shortcomings identified above:

- new definitions for "equity claims", "equity interests", and "shareholders" have been provided to broaden the nature of the equity interests and claims expressly subject to the BIA and the CCAA;
- new BIA, section 54.1, and new CCAA, section 22.1, both provide that equity claims are to be included in the same class and may not vote in respect of a proposal or plan unless the supervising court otherwise orders;
- new BIA, section 59(4), and new CCAA, section 6(2), provide that supervising courts may grant orders effecting changes to a debtor's constating documents in accordance with a sanctioned proposal or plan without the need for any shareholder or equity approval to effect any changes to those constating documents that might otherwise be lawfully made;
- new BIA, section 140.1, provides that a creditor is not entitled to a dividend under a proposal in respect of an equity claim until all other claims have been satisfied;
- new BIA, section 39(2)(1.7), and new CCAA, section 6(8), provide that no proposal or plan providing for the payment of an equity claim may be approved or sanctioned by the court unless the proposal or plan also provides that all other claims are to be paid in full before the equity claim is to be paid;
- new BIA, section 54(2)(d), dispenses with the need for any equity claim vote to approve a proposal as unsecured creditors, unless the court orders otherwise;
- new BIA, section 66(1.4), provides that the proposal provisions may be used in conjunction with any federal or provincial Act that authorizes or provides for compromises or arrangements between a corporation and its shareholders; and

- new BIA, section 65.13(1), and new CCAA, section 36(1), each provide for the ability of a court to authorize a sale or other disposition of assets out of the ordinary course of business despite any requirement for shareholder approval, whether under federal or provincial law.

## VII. PRIORITY OF CHARGES IN BIA AND CCAA PROCEEDINGS[58]

Statute c.47 would codify a number of super-priority charges, some having statutory priority in bankruptcy and others depending on court order during a reorganization, against the current and fixed assets of a debtor.[59] All such charges can rank in priority to the claims of existing secured lenders. The newly created charges relate to employee wage and expense claims;[60] certain unremitted pension plan contributions;[61] so-called "DIP loans";[62] administrative expenses;[63] and director and officer liabilities.[64] These charges are in addition to existing rights in respect of deemed trusts for employee source deductions[65] and the rights of suppliers.[66]

Statute c.47 supplements these liquidation priorities by providing that no proposal or plan of arrangement shall be approved by the court unless it provides for the payment of unremitted employee source deductions, employees' preferred (now secured) claims, and the pension plan amounts outlined in sections 81.5 and 81.6.[67] The statute contains provisions to waive this last requirement if an agreement otherwise is reached and approved by the relevant pension regulator.

Statute c.47 ranks the relative priorities of the following items in descending order: (a) existing supplier rights; (b) statutory deemed trusts relating to source deductions; (c) the newly created super-priority charges for employee related claims; and (d) existing secured claims.[68] However, the amended legislation neither specifies the relative priorities of court-ordered charges that may be granted in respect of DIP loans, administrative expenses, and director and officer liabilities,

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58 See further Chapter 5, above.

59 As noted in the LRTF Report, *supra* note 2 at 15-16.

60 Statute c.47, *supra* note 1, s. 67; ss. 81.3 and 81.4, amended BIA.

61 Statute c.47, *ibid.*; ss. 81.5, 81.6, amended BIA.

62 Statute c.47, *ibid.*, s. 36 and s. 128; s. 50.6(1), amended BIA, and s. 11.2, amended CCAA, respectively.

63 Statute c.47, *ibid.*, s. 42 and s. 128; s. 64.2, amended BIA, and s. 11.52, amended CCAA, respectively.

64 Statute c.47, *ibid.*; s. 64.1, amended BIA, and s. 11.51, amended CCAA.

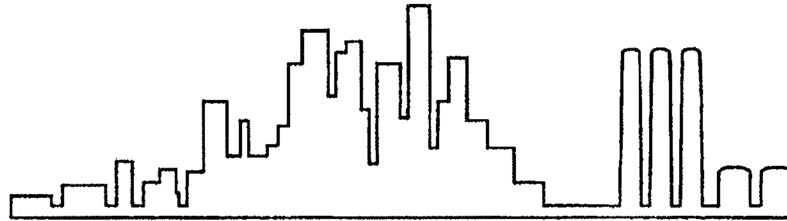
65 BIA, *supra* note 6, s. 67(3).

66 *Ibid.*, ss. 81.1 and 81.2.

67 Statute c.47, *supra* note 1, s. 39 and s. 126; s. 60(1.4), amended BIA, and s. 6, amended CCAA, respectively.

68 Statute c.47, *ibid.*, s. 67; ss. 81.1-81.6, amended BIA.

# TAB 20



# CANADIAN COMMERCIAL REORGANIZATION

## PREVENTING BANKRUPTCY

### VOLUME 2

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because it will determine how many votes creditors are able to cast and is, therefore, an important part of the prognostic analysis of the outcome of the vote at the creditors meeting. Section 6 imposes a "one dollar/one vote" type of scheme for creditor voting. Thus, creditors with large claims will control large blocks of votes and those with small claims will control small ones.

***Characterization of a Claim***

**5.1850** Section 12(1) defines a claim as "any indebtedness, liability or obligation of any kind that, if unsecured, would be a debt provable in bankruptcy within the meaning of the *Bankruptcy and Insolvency Act*". The means by which a claim is provable under the CCAA are analogous to those under the BIA.[63]

**5.1900** In submitting a proof of claim under the CCAA, the creditor must establish whether the claim is secured or not. Section 2 provides a definition for both "secured creditor" and "unsecured creditor". Under the Act, secured creditors have been held to include:

aggregate basis. The scale provided that creditors of less than $100,000 were be paid between 90-95% of the claim in cash while those in excess received shares on a formula basis. A creditor who purchased a number of small claims by way of assignment applied to the court seeking to amend the plan in order that its claims be treated on an individual and not aggregate basis. The court dismissed the motion, partly because aggregation clauses are not inherently unfair and sliding scale provisions which aim to protect smaller creditors represent reasonable policy considerations. In *TRG Services Inc. (Re)* (2006), 26 C.B.R. (5th) 203 (Ont. S.C.J.), C, a creditor, whose security interest had attached but had not been perfected, filed for a proof of claim as a secured creditor six months after the CCAA order had been issued and a seven day "come-back" period to all creditors had expired. The court lifted the stay order in order to allow C to register and perfect the security interest. The current secured creditors in this matter argued that they would face prejudice by the addition of C since the reorganization plans had commenced on the basis of an understanding of a specified quantum of secured and unsecured claims. The court acknowledged this, and allowed creditors to claim reasonable expenses from C for any prejudice that occurred due to C's late filing.

63 For discussion of claims provable under the BIA, see paras. 5.3650-5.7600, *infra*. This line of reasoning regarding the meaning of "claim" in the CCAA was reiterated in *Jameson House Properties Ltd (Re)* (2009), 57 C.B.R. (5th) 1, 2009 BCSC 844, affd 59 C.B.R. (5th) 21, 2009 BCCA 339. The appellants were found not to be creditors. Their only potential "claim" was a right under the *Real Estate Development and Marketing Act*, S.B.C. 2004, c. 41, to sue for return of their deposits on condominium properties in the course of being built. This was not a claim in debt or damages, but rather an action against the trustee holding the deposits for the return of specific property. The appellants were found not to have any rights of rescission or to the return of their deposits under the consumer protection legislation. The British Columbia Court of Appeal noted in obiter that even if the appellants had been found to have rights under the consumer protection legislation, their only claim would be against the trustee and not the bankrupt party, therefore their rights would still not constitute a "debt or liability . . . provable in bankruptcy".

64 [Footnote deleted.]

(a) lienholders;[65]
(b) holders of security under the *Bank Act*;[66]
(c) a provincial Crown with a lien on a debtor's property under provincial legislation;[67] and
(d) beneficial holders of a proprietary interest in the debtor company.[68]

It is therefore a very wide definition.

**5.1950** Under the CCAA, unsecured creditors have been held to include:

(a) preferred creditors under the BIA;[69]
(b) employees of the debtor company;[70] and

65 In *NsC Diesel Power Inc. (Re)* (1990), 79 C.B.R. (N.S.) 1, 97 N.S.R. (2d) 295 (S.C.), NsC Power was incorporated for the purpose of building a facility for testing and certifying diesel engines. The issue was whether subcontractors with liens against the company's property should be included in the class of secured creditors. It was held that the subcontractors fell into the plain meaning of "secured creditor" notwithstanding the fact that the lienholders did not have a direct contract with the debtor. The court held that the definition of a secured creditor under the CCAA is wider than under the BIA and is wide enough to include the subcontractors as secured creditors. However, see *Pine Valley Mining Corp. (Re)* (2007), 63 C.L.R. (3d) 314 (B.C.S.C.). In this case, three creditor mining companies performed work and services for a debtor company with respect to coal mines on land owned by the debtor. The debtor subsequently entered into CCAA proceedings. The creditor mining companies claimed liens against property of the debtor which, if successful, would have had the effect of making them secured creditors. The debtor brought a petition for a declaration that the creditors did not have valid and enforceable liens against any of its assets, property or interests. The court granted the petition and ruled that the *Builders Lien Act*, S.B.C. 1997, c. 45, excludes coal miners from its protective regime. Furthermore, the creditors could not invoke or create any common law lien rights that were not legislated. The exclusion of coal mining from the *Builders Lien Act* did not necessarily create an unfair legislative gap as coal miners could secure payment under a long-term contract if they wished to be assured of secured creditor status. In *Northern Sun Exploration Co. (Re)* (2009), 51 C.B.R. (5th) 125 (Alta. Q.B.), a builders' lien was deemed sufficient to create a secured interest in property even if the underlying property had no value.

66 S.C. 1991, c. 46, s. 427. In *Groupe Bovac Ltée v. Banque Laurentide du Canada* (1991), 9 C.B.R. (3d) 248 (Que. C.A.), although the term "secured creditor" under the CCAA was held to be broad enough to include a security holder under s. 178 [see now s. 427] of the *Bank Act*, the debtor in this case was unable to seek protection from its creditors under the CCAA. The court held that the CCAA could not operate because the debtor had not formulated a proposal before filing a petition for protection under the Act.

67 A provincial Crown with a lien on a debtor's property under provincial legislation does not constitute a secured creditor under the BIA. See, *e.g.*, *Sous-Ministre du Revenue du Quebec v. Wynden Canada Inc.* (1982), 47 C.B.R. (N.S.) 76 (Que. S.C.), where the Ministry of Revenue was found to be a secured creditor within the context of the CCAA. The court held that since the CCAA defines both secured and ordinary creditors, it is separate and distinct from definitions of the same under the BIA. The court stated that whoever possesses a privilege under the *Civil Code of Lower Canada* or a statutory provision falls within the meaning of a "secured creditor" under the CCAA.

68 See *Citibank Canada v. Chase Manhattan Bank of Canada* (1991), 5 C.B.R. (3d) 165, 4 B.L.R. (2d) 147 (Ont. Ct. (Gen. Div.)). Given that under s. 2 of the Act, a "secured creditor" includes a "holder" of certain securities, the court found that "holder" must be given a liberal interpretation in keeping with the broad remedial nature of the CCAA and includes beneficial holders of any bond or proprietary interest.

69 The CCAA does not distinguish between preferred and unpreferred creditors as the BIA does. See, *e.g.*, *Simplex Floor Finishing Appliance Co. (Re)* (1941), 79 Que. C.S. 317.

70 In *Woodward's Ltd. (Re)* (1993), 20 C.B.R. (3d) 74, 84 B.C.L.R. (2d) 206 (C.A.), the plan of arrangement classified the employees with trade suppliers and other unsecured creditors. The employees challenged the classification scheme, claiming they should be classed separately. The

(c) a landlord in respect of both unpaid rent and any contingent claim for unliquidated damages as a result of the repudiation of the lease.[71]

It has been held that a holder of a guarantee given by the debtor company can prove a claim for the full amount of the debt owing by the principal debtor.[72]

**5.2000** In *Cole v. Central Capital Corp.*,[73] the chair and chief executive officer of a trust company resigned and entered into a contract of disengagement, usually known as a severance agreement. The agreement provided for payments for a three-year period and for certain supplementary pension provisions. Just before the second anniversary of the agreement, the company was extended protection under the CCAA and under the terms of the order payments to its creditors were suspended. The order provided that the company pay termination and severance pay to its employees in accordance with the *Employment Standards Act*.[74] At issue were whether the individual was an employee of the company and whether the supplementary pension provisions in the severance agreement imposed a trust obligation on the company to provide those funds in priority to unsecured claimants. These issues had to be addressed

court held, however, that there was sufficient commonality of interest to keep the employees in the class. In this case, the legal rights of trade suppliers and employees were the same because secured and preferred amounts payable by provincial law and the BIA had already been paid. The employees claim related only to damages for the failure of Woodward's to give them reasonable notice of termination. See also *Parisian Cleaners & Laundry Ltd. v. Blondin* (1938), 20 C.B.R. 452, 66 Que. K.B. 456 (C.A.), where a dismissed manager claimed three months' wages from an employer who had an arrangement under the Act. The manager argued that his claim was privileged and, therefore, secured because of the *Civil Code of Lower Canada*. The court held that the Code did not confer a privilege on the manager so his claim was not secured.

71 In *Sklar-Peppler Furniture Corp. v. Bank of Nova Scotia* (1991), 86 D.L.R. (4th) 621, 8 C.B.R. (3d) 312 (Ont. Ct. (Gen. Div.)), the insolvent debtor terminated lease agreements with three realty landlords. Despite the protests of the landlords about the arrangement's interference with their contractual rights, the court approved the plan which classified them as unsecured creditors. In *Grafton-Fraser Inc. v. Canadian Imperial Bank of Commerce* (1992), 90 D.L.R. (4th) 285, 11 C.B.R. (3d) 161 (Ont. Ct. (Gen. Div.)), the order containing the stay had, amongst other interesting powers, the power to terminate leases. The insolvent retail chain also terminated lease agreements with a number of shopping mall landlords who challenged the debtor's ability to carry out such activities through the court. However, before the matter was litigated, the parties settled their differences and one of the landlords became a new creditor in the plan of reorganization.

72 *Algoma Steel Corp. v. Royal Bank* (1992), 93 D.L.R. (4th) 98, 11 C.B.R. (3d) 11 (Ont. C.A.), leave to appeal to S.C.C. refused 145 N.R. 395*n*. In this case, it was also held that the holder of the guarantee need not file a claim but can proceed against the principal debtor without being affected by a plan made under the Act. "Indebtedness, liability or obligation" is to be determined by reference to whether a claim is a debt provable in bankruptcy under the BIA. However, in order to be valid, the guarantee must be made in accordance with the relevant provincial statute. In *Alpha Marathon International Inc. (Re)* (1998), 82 A.C.W.S. (3d) 633 (Ont. Ct. (Gen. Div.)), affd 138 O.A.C. 135 (C.A.), a company guaranteed a loan of its shareholder contrary to s. 20 of the Ontario *Business Corporations Act*. The guarantee did not represent a valid proof of claim for the creditor when the company subsequently filed a proposal under the BIA.

73 (1994), 94 C.L.L.C. 14,044 (Ont. Ct. (Gen. Div.)).

74 R.S.O. 1990, c. E.14 (Repealed S.O. 2000, c. 41, s. 144(1)).

in order to determine whether a claim could be made under the CCAA. The court found that the individual was not an employee and was not entitled to the pension. Therefore, the claim could not be characterized as provable because it did not come within s. 12(1). Blair J. did note, however, that if the individual had been so entitled, his claim would have priority in relation to unsecured creditors.

**5.2050** In *Central Capital Corp (Re)*,[75] the Court of Appeal determined that preference shares with a fixed date for retraction by the debtor corporation did not constitute a debt or liability pursuant to s. 121 of the BIA and thus were not provable claims within the meaning of s. 12(1) of the CCAA. The first appellant, McCutcheon, sold shares in a company to the debtor corporation and received cash and paper in the form of preferred shares. These preferred shares carried with them a retractable date. The debtor corporation was required to redeem these shares as long as redemption would not be contrary to applicable laws or rights. The shares also carried with them an entitlement to receive dividends when declared; no dividends were in fact declared.

**5.2060** The second appellant, SYH, sold and transferred shares it held in other companies to the debtor corporation. In payment for this transfer, the debtor corporation issued paper to SYH as the exclusive form of payment for the sold shares in the form of a different series of preferred shares. These preferred shares contained the same retractable clause as those of McCutcheon, however, the retractable date was the fifth anniversary of their issuance, which was two years after the date for proving claims under the CCAA.

**5.2070** The majority held that the preference shares issued to acquire shares in the operating entity as assets of the debtor corporation were on a true characterization equity, despite having features of both equity and debt in the transaction.[75a]

**5.2075** In *Nelson Financial Group Ltd. (Re)*,[75b] a motion was brought before the court to determine if the claims advanced by the preferred shareholders were equity claims. Recent amendments to s. 2 of the CCAA had incorporated a definition of equity claims. The court stated in *Nelson* that the definition incorporated the historical treatment of the term. The court held that despite characteristics of debt claims, the claims were equity claims. The finding was based on the fact that the investors were given the option to invest in promissory notes; the investors had the right to receive dividends; the preferred shares provided that they ranked ahead of common shareholders, implying that they ranked behind

75 (1996), 132 D.L.R. (4th) 223, 27 O.R. (3d) 494 (C.A.).

75a See also *EarthFirst Canada Inc. (Re)* (2009), 56 C.B.R. (5th) 102, 2009 ABQB 316, where the court held that the potential claims of flow-through shareholders against the debtor company were equity obligations rather than debt or creditor obligations because the debt features associated with indemnity were secondary to the equity features of the investment.

75b (2010), 71 C.B.R. (5th) 153 (Ont. S.C.J.).

creditors; and the shares were treated as equity in the debtor's financial statements. Moreover, in *Return on Innovation Capital Ltd. v. Gandi Innovations Ltd.*,[75c] in accordance withs ss. 2(1) and 6(8) of the CCAA, the court held that the claims in both the arbitration and CCAA process were equity claims.

**5.2080** In *Teleglobe Inc. (Re)*,[75d] the court stated that it had to protect the rights of both foreign and domestic creditors. This case involved a motion by the moving party bank for the Canadian debtor company to pay its Columbian branch company from the money it received from CCAA proceedings. The bank was a creditor in the Columbian branch company and also had a guarantee from the Canadian debtor company for the debt owed by the Columbian branch company. However, the Columbian branch company was already indebted to the Canadian debtor company for an amount of greater value than that sought by the bank. The court was unable to grant the motion as that would give the bank a preferred status over all other creditors and would be especially unfair for the creditors of the Canadian debtor company.

**5.2100** Prior to the 1997 amendments, the CCAA made no reference to the claims of the Crown. The case law had held that the Crown was not bound by a CCAA compromise or arrangement.[76] The effect was that the Crown was not stayed from taking or continuing enforcement proceedings during the reorganization period, thus undermining the reorganization effort. Section 21[77] of the 1997 CCAA binds the Crown as well as workers compensation bodies to the provisions of the CCAA. Under the 1997 Act, both federal and provincial Crown claims provable in a reorganization proceeding rank as unsecured claims pursuant to s. 18.4(1) [now repealed]. Thus, Crown claims are to be treated the same as those of ordinary unsecured creditors. The exceptions with respect to Crown claims and deemed trusts parallel those of the BIA in that the Crown retains priority for claims regarding income tax, employment insurance,

75c (2012), 211 A.C.W.S. (3d) 264, 2012 ONCA 10.

75d (2005), 10 C.B.R. (5th) 120 (Ont. S.C.J.).

76 See *Fine's Flowers Ltd. v. Fine's Flowers Ltd. (Creditors)* (1992), 87 D.L.R. (4th) 391, 10 C.B.R. (3d) 87, 7 O.R. (3d) 193, 4 B.L.R. (2d) 293 (Ont. Ct. (Gen. Div.)), revd 108 D.L.R. (4th) 765, 22 C.B.R. (3d) 1, 16 O.R. (3d) 315, 65 O.A.C. 316 (Ont. C.A.). See also *Gaston H. Poulin Contractor Ltd. (Re)* (1992), 91 D.L.R. (4th) 96, 10 C.B.R. (3d) 1, 4 B.L.R. (2d) 282, [1992] 2 C.T.C. 373, 92 D.T.C. 6388 (Ont. Ct. (Gen. Div.)), where the court did not follow the lower court decision in *Fine's Flowers*, even before its reversal by the Court of Appeal. In *Gaston H. Poulin*, a company failed to remit source deductions to the Receiver General. Revenue Canada delivered a "Requirement to Pay" under the *Income Tax Act*. The company filed for protection under the CCAA and had proceedings against it stayed. The issue was whether the Crown was bound by the Act or whether it could pursue its statutory remedies. Since the prior Act did not contain a specific provision binding the Crown, the court held that the Act did not prevent the Crown from pursuing remedies under the *Income Tax Act*. The older case law is to the same effect: see, *e.g.*, *M.N.R. v. Roxy Frocks Manufacturing Co.* (1936), 18 C.B.R. 132, 62 Que. K.B. 113 (C.A.); *Fairview Industries Ltd. (Re)* (1991), 11 C.B.R. (3d) 43, 109 N.S.R. (2d) 12 (S.C.); *R. v. Kussner*, [1936] 4 D.L.R. 752, 18 C.B.R. 58, [1936] Ex. C.R. 206 (Can. Ex. Ct.).

77 Enacted 1997, c. 12, s. 126.

# TAB 21

# LAW OF BANKRUPTCY AND INSOLVENCY IN CANADA

REVISED EDITION

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#### *ii. Equity claims*

Section 2 of the BIA is referenced in s. 2 of the CCAA which 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. Section 121(1) of the BIA describes claims provable. Historically, the claims and rights of shareholders were not treated as provable claims and ranked after creditors of an insolvent corporation in a liquidation. 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. Equity investors bear the risk relating to the integrity and character of management.

The amendments to the CCAA came into force on September 18, 2009 and incorporated the historical treatment of equity claims. Section 2 clearly provides that 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. According to ss. 6(8) and 22.1, equity claims are rendered subordinate to those of creditors. In one decision, the characteristics suggestive of a debt claim and of an equity claim were discussed: [6.2]

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

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

(c) The preference share conditions provided that on a liquidation, dissolution or winding up, the preferred shareholders ranked ahead of common shareholders. It was implicit that they would rank behind creditors.

(d) The preferred shareholders did not receive copies of the financial statements, nonetheless, the shares were treated as equity in the financial statements and in its books and records.

### b. Wages

Claims for wages, even if subject to orders under provincial labour standards legislation, rank *pari passu* without priority over the other ordinary claims.[7] No preference is granted to a claim for services rendered to the bankrupt by a father, mother, child, brother, sister, aunt or uncle by blood or marriage.[8] However, claims for services rendered by a spouse or former spouse in connection with the bankrupt's business are only paid after the claims of all other creditors have been satisfied.[9] No preference is granted to a claim for work done, or services rendered in any capacity, by a director or officer against the bankrupt corporation, although an ordinary claim is still available.[10]

**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**

Court of Appeal File No. M41654 / Superior Court File No. CV-12-9667-00-CL

***ONTARIO***
**SUPERIOR COURT OF JUSTICE**
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