Court of Appeal File Nos. C56115, C56118, C56125
Court File No. CV-12-9667-00CL

COURT OF APPEAL FOR ONTARIO

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

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

BOOK OF AUTHORITIES OF THE RESPONDENT, THE AD HOC COMMITTEE OF NOTEHOLDERS OF SINO-FOREST CORPORATION

VOLUME 2 OF 2

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Case Name:
R. v. Proulx

Her Majesty The Queen, appellant;
v.
Jeromie Keith D. Proulx, respondent, and
The Attorney General of Canada and the Attorney General for Ontario, interveners.

[2000] S.C.J. No. 6

[2000] A.C.S. no 6

2000 SCC 5

2000 CSC 5

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44 W.C.B. (2d) 479

File No.: 26376.

Supreme Court of Canada

1999: May 25, 26 / 2000: January 31.

Present: Lamer C.J. and L'Heureux-Dubé, Gonthier, Cory*, McLachlin, Iacobucci, Major, Bastarache and Binnie JJ.

ON APPEAL FROM THE COURT OF APPEAL FOR MANITOBA (132 paras.)

* Cory J. took no part in the judgment.

Criminal law -- Sentencing -- Conditional sentences -- Accused pleading guilty to dangerous driving causing death and dangerous driving causing bodily harm and receiving sentence of 18 months of incarceration -- Whether Court of Appeal erred in substituting conditional custodial sentence for jail term -- Proper interpretation and application of conditional sentencing regime -- Distinction between conditional sentence of imprisonment and suspended sentence with probation -- Meaning of "safety of the community" -- Criminal Code, R.S.C., 1985, c. C-46, ss. 742.1, 742.3.

After a night of partying involving consumption of some alcohol, the accused decided to drive his friends home even though he knew that his vehicle was not mechanically sound. For a period of 10 to 20 minutes, the accused, who had only seven weeks of experience as a licensed driver, drove erratically, weaving in and out of traffic, tailgating and trying to pass other vehicles without signalling, despite steady oncoming traffic and slippery roads. As the accused was trying to pass another vehicle, he drove his car into an oncoming lane of traffic, side-swiped a first car and crashed into a second one. The driver of that second vehicle was seriously injured. The accident also claimed the life of a passenger in the accused's car. The accused was in a near-death coma for some time, but ultimately recovered from his injuries. The accused entered guilty pleas to one count of dangerous driving causing death and one count of dangerous driving causing bodily harm. He was sentenced to 18 months of incarceration, to be served concurrently on both charges. The sentencing judge concluded that a conditional sentence pursuant to s. 742.1 of the Criminal Code, which would allow the accused to serve his sentence in the community, would not be appropriate because it would be inconsistent with the objectives of denunciation and general deterrence. The Court of Appeal allowed the appeal and substituted a conditional custodial sentence for the jail term.

Held: The appeal should be allowed.

The 1996 sentencing reforms ("Bill C-41") substantially reformed Part XXIII of the Code, and introduced, inter alia, an express statement of the purposes and principles of sentencing, provisions for alternative measures for adult offenders and a new type of sanction, the conditional sentence of imprisonment. Bill C-41 in general and the conditional sentence in particular were enacted both to reduce reliance on incarceration as a sanction and to increase the use of principles of restorative justice in sentencing.

A conditional sentence should be distinguished from probationary measures. Probation is primarily a rehabilitative sentencing tool. By contrast, Parliament intended conditional sentences to include both punitive and rehabilitative aspects. Therefore, conditional sentences should generally include punitive conditions that are restrictive of the offender's liberty. Conditions such as house arrest should be the norm, not the exception.

No offences are excluded from the conditional sentencing regime except those with a minimum term of imprisonment, nor should there be presumptions in favour of or against a conditional sentence for specific offences.

Section 742.1 of the Code lists four criteria that a court must consider before deciding to impose a conditional sentence: (1) the offender must be convicted of an offence that is not punishable by a minimum term of imprisonment; (2) the court must impose a term of imprisonment of less than two years; (3) the safety of the community would not be endangered by the offender serving the sentence in the community; and (4) a conditional sentence would be consistent with the fundamental purpose and principles of sentencing set out in ss. 718 to 718.2.

The requirement in s. 742.1(a) that the judge impose a sentence of imprisonment of less than two years does not require the judge to first impose a sentence of imprisonment of a fixed duration before considering whether that sentence can be served in the community. Although this approach is suggested by the text of s. 742.1(a), it is unrealistic and could lead to unfit sentences in some cases. Instead, a purposive interpretation of s. 742.1(a) should be adopted. In a preliminary determination, the sentencing judge should reject a penitentiary term and probationary measures as inappropriate. Having determined that the appropriate range of sentence is a term of imprisonment of less than two years, the judge should then consider whether it is appropriate for the offender to serve his or her sentence in the community. As a corollary of the purposive interpretation of s. 742.1(a), a conditional sentence need not be of equivalent duration to the sentence of incarceration that would otherwise have been imposed. The sole requirement is that the duration and conditions of a conditional sentence make for a just and appropriate sentence.

The requirement in s. 742.1(b) that the judge be satisfied that the safety of the community would not be endangered by the offender serving his or her sentence in the community is a condition precedent to the imposition of a conditional sentence, and not the primary consideration in determining whether a conditional sentence is appropriate. In making this determination, the judge should consider the risk posed by the specific offender, not the broader risk of whether the imposition of a conditional sentence would endanger the safety of the community by providing insufficient general deterrence or undermining general respect for the law. Two factors should be taken into account: (1) the risk of the offender re-offending; and (2) the gravity of the damage that could ensue in the event of re-offence. A consideration of the risk posed by the offender should include the risk of any criminal activity, and not be limited solely to the risk of physical or psychological harm to individuals.

Once the prerequisites of s. 742.1 are satisfied, the judge should give serious consideration to the possibility of a conditional sentence in all cases by examining whether a conditional sentence is consistent with the fundamental purpose and principles of sentencing set out in ss. 718 to 718.2. This follows from Parliament's clear message to the judiciary to reduce the use of incarceration as a sanction.

A conditional sentence can provide significant denunciation and deterrence. As a general matter, the more serious the offence, the longer and more onerous the conditional sentence should be. There may be some circumstances, however, where the need for denunciation or deterrence is so pressing that incarceration will be the only suitable way in which to express society's condemnation of the offender's conduct or to deter similar conduct in the future.

Generally, a conditional sentence will be better than incarceration at achieving the restorative objectives of rehabilitation, reparations to the victim and the community, and promotion of a sense of responsibility in the offender and acknowledgment of the harm done to the victim and the community.

Where a combination of both punitive and restorative objectives may be achieved, a conditional sentence will likely be more appropriate than incarceration. Where objectives such as denunciation and deterrence are particularly pressing, incarceration will generally be the preferable sanction. This may be so notwithstanding the fact that restorative goals might be achieved. However, a conditional sentence may provide sufficient denunciation and deterrence, even in cases in which restorative objectives are of lesser importance, depending on the nature of the conditions imposed, the duration of the sentence, and the circumstances of both the offender and the community in which the conditional sentence is to be served. A conditional sentence may be imposed even where there are aggravating circumstances, although the need for denunciation and deterrence will increase in these circumstances.

No party is under a burden of proof to establish that a conditional sentence is either appropriate or inappropriate in the circumstances. The judge should consider all relevant evidence, no matter by whom it is adduced. However, it would be in the offender's best interests to establish elements militating in favour of a conditional sentence.

Sentencing judges have a wide discretion in the choice of the appropriate sentence. They are entitled to considerable deference from appellate courts. Absent an error in principle, failure to consider a relevant factor, or an overemphasis of the appropriate factors, a court of appeal should only intervene to vary a sentence imposed at trial if the sentence is demonstrably unfit.

In this case the sentencing judge considered that a term of imprisonment of 18 months was appropriate and declined to permit the accused to serve his term in the community. She found that, while the accused would not endanger the safety of the community by serving a conditional sentence, such a sentence would not be in conformity with the objectives of s. 718. In her view, even if incarceration was not necessary to deter the accused from similar future conduct or necessary for his rehabilitation, incarceration was necessary to send a strong message to denounce the accused's conduct and to deter others from engaging in similar conduct. While the sentencing judge seems to have proceeded according to a rigid two-step process, in deviation from the approach set out in these reasons, an 18-month sentence of incarceration was not demonstrably unfit for these offences and this offender. The offences here were very serious, and had resulted in a death and in severe bodily harm. Moreover, dangerous driving and impaired driving may be offences for which harsh sentences plausibly provide general deterrence. The Court of Appeal erred in holding that the sentencing judge had given undue weight to the objective of denunciation. Absent evidence that the sentence was demonstrably unfit, the Court of Appeal should not have interfered to substitute its own opinion for that of the sentencing judge. The sentencing judge did not commit a reversible error in principle and she appropriately considered all the relevant factors. Accordingly, the 18-month sentence of incarceration imposed by her should be restored. Since the accused has already served the conditional sentence imposed by the Court of Appeal in its entirety, and the Crown stated in oral argument that it was not seeking any further punishment, the service of the sentence of incarceration should be stayed.

Cases Cited

Considered: R. v. Gladue, [1999] 1 S.C.R. 688; referred to: R. v. Gardiner, [1982] 2 S.C.R. 368; R. v. Chaisson, [1995] 2 S.C.R. 1118; R. v. M. (C.A.), [1996] 1 S.C.R. 500; R. v. Taylor (1997), 122 C.C.C. (3d) 376; R. v. Ziatas (1973), 13 C.C.C. (2d) 287; R. v. Caja (1977), 36 C.C.C. (2d) 401; R. v. Lavender (1981), 59 C.C.C. (2d) 551; R. v. L. (1986), 50 C.R. (3d) 398; R. v. McDonald (1997), 113 C.C.C. (3d) 418; R. v. Brady (1998), 121 C.C.C. (3d) 504; R. v. Shropshire, [1995] 4 S.C.R. 227; Cunningham v. Canada, [1993] 2 S.C.R. 143; R. v. Wismayer (1997), 115 C.C.C. (3d) 18; Gagnon v. La Reine, [1998] R.J.Q. 2636; R. v. Pierce (1997), 114 C.C.C. (3d) 23; R. v. Ursel (1997), 96 B.C.A.C. 241; R. v. O'Keefe (1968), 53 Cr. App. R. 91; R. v. Maheu, [1997] R.J.Q. 410, 116 C.C.C. (3d) 361; R. v. Parker (1997), 116 C.C.C. (3d) 236; R. v. Horvath, [1997] 8 W.W.R. 357; R. v. McDonnell, [1997] 1 S.C.R. 948; Kwiatkowsky v. Minister of Employment and Immigration, [1982] 2 S.C.R. 856; Gravel v. City of St-Léonard, [1978] 1 S.C.R. 660; Pfizer Co. v. Deputy Minister of National Revenue for Customs and Excise, [1977] 1 S.C.R. 456; Tupper v. The Queen, [1967] S.C.R. 589; Goodyear Tire and Rubber Co. of Canada v. T. Eaton Co., [1956] S.C.R. 610; R. v. Lyons, [1987] 2 S.C.R. 309; R. v. Fleet (1997), 120 C.C.C. (3d) 457; R. v. W. (G.), [1999] 3 S.C.R. 597; R. v. McVeigh (1985), 22 C.C.C. (3d) 145; R. v.

Biancofiore (1997), 119 C.C.C. (3d) 344; R. v. Blakeley (1998), 40 O.R. (3d) 541; R. v. Hollinsky (1995), 103 C.C.C. (3d) 472; R. v. R.A.R., [2000] 1 S.C.R. 163, 2000 SCC 8.

Statutes and Regulations Cited

Act to amend the Criminal Code (sentencing) and other Acts in consequence thereof, S.C. 1995, c. 22.
Corrections and Conditional Release Act, S.C. 1992, c. 20, ss. 112(1), 133.
Corrections and Conditional Release Regulations, SOR/92-620, s. 161.

Criminal Code, R.S.C., 1985, c. C-46, ss. 259(2), Part XXIII [repl. 1995, c. 22, s. 6], 718, 718.1, 718.2 [am. 1997, c. 23, s. 17], 718.3, 722, 723, 732.1(2), (3)(g.1) [ad. 1999, c. 32, s. 6], (g.2) [idem], (h), 732.2 (5), 733.1(1), 734(2), 742.1(a), (b) [repl. 1997, c. 18, s. 107.1], 742.3(1), (2)(f), 742.6(9).

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Roberts, Julian V. "The Hunt for the Paper Tiger: Conditional Sentencing after Brady" (1999), 42 Crim. L.Q. 38.
Rosenberg, Marc. "Recent Developments in Sentencing", a paper prepared for the National Judicial Institute's Supreme Court of Nova Scotia Education Seminar in Halifax, February 25-26, 1999.

APPEAL from a judgment of the Manitoba Court of Appeal (1997), 123 Man. R. (2d) 107, 159 W.A.C. 107, 121 C.C.C. (3d) 68, [1998] 5 W.W.R. 1, [1997] M.J. No. 563 (QL), allowing the accused's appeal from a sentence of 18 months of incarceration imposed by Keyser J. Appeal allowed.

Matthew Britton, for the appellant.
Sandra L. Chapman and Wanda Garreck, for the respondent.
S. Ronald Fainstein, Q.C., for the intervener the Attorney General of Canada.
Kenneth L. Campbell and Gregory J. Tweney, for the intervener the Attorney General for Ontario.

Solicitor for the appellant: Manitoba Justice, Winnipeg.
Solicitors for the respondent: Killeen Chapman Garreck, Winnipeg.
Solicitor for the intervener the Attorney General of Canada: The Deputy Attorney General of Canada, Ottawa.
Solicitors for the intervener the Attorney General for Ontario: The Ministry of the Attorney General, Toronto.

Solicitor for the intervener the Attorney General for Ontario: The Ministry of the Attorney General, Toronto.

The judgment of the Court was delivered by

1 **LAMER C.J.**:-- By passing the Act to amend the Criminal Code (sentencing) and other Acts in consequence thereof, S.C. 1995, c. 22 ("Bill C-41"), Parliament has sent a clear message to all Canadian judges that too many people are being sent to prison. In an attempt to remedy the problem of overincarceration, Parliament has introduced a new form of sentence, the conditional sentence of imprisonment.

2 As a matter of established practice and sound policy, this Court rarely hears appeals relating to sentences: see R. v. Gardiner, [1982] 2 S.C.R. 368, at p. 404, R. v. Chaisson, [1995] 2 S.C.R. 1118, at para. 7, and R. v. M. (C.A.), [1996] 1 S.C.R. 500, at para. 33. However, we have decided to hear this case and four related cases because they afford the Court the opportunity to set out for the first time the principles that govern the new and innovative conditional sentencing regime. Given the inevitable length of these reasons, I have summarized the essentials at para. 127.

I. Factual Background

3 On the morning of November 1, 1995, after a night of partying involving consumption of some alcohol, the respondent decided to drive his friends home even though he knew that his vehicle was not mechanically sound. For a period of 10 to 20 minutes, the respondent, who had only seven weeks of experience as a licensed driver, drove erratically, weaving in and out of traffic, tailgating and trying to pass other vehicles without signalling, despite steady oncoming traffic and slippery roads. As the respondent was trying to pass another vehicle, he drove his car into an oncoming lane of traffic, side-swiped a first car and crashed into a second one. The driver of the second vehicle was seriously injured. The accident also claimed the life of a passenger in the respondent's car. The respondent was in a near-death coma for some time, but ultimately recovered from his injuries. The respondent entered guilty pleas to one count of dangerous driving causing death and one count of dangerous driving causing bodily harm.

II. Judgments Below

A. Manitoba Court of Queen's Bench

4 On June 5, 1997, Keyser J. sentenced the respondent to 18 months of incarceration, to be served concurrently on both charges. In her reasons for sentence, the judge explained that she was not prepared to order a penitentiary term because the respondent was only 18 years old at the time of the accident, he had no prior record and he himself was seriously injured in the accident. She also noted that the respondent was now employed and expecting a first child with his girlfriend. She conceded that the amount of alcohol involved -- one and a half to two beers -- was probably not a major factor in the accident. However, she found that the respondent's knowledge that he was operating an unsafe vehicle, the fact that, prior to the accident, he had just barely avoided rear-ending another vehicle and his egregious driving in general that morning warranted such a sentence.

5 Keyser J. then turned her attention to the question of whether it was appropriate to allow the respondent to serve his sentence in the community, pursuant to s. 742.1 of the Criminal Code, R.S.C., 1985, c. C-46. She took notice of the May 2, 1997 amendment to s. 742.1, which added to that section

an express reference to the fundamental purpose and principles of sentencing listed in ss. 718 to 718.2 of the Code. She concluded that this amendment meant that she had to refer to the fundamental purpose and principles of sentencing in deciding whether to impose a conditional sentence. In the case at hand, she found that even though the respondent would not endanger the community and a jail sentence would not be necessary to deter him from similar conduct in the future or to rehabilitate him, a conditional sentence would not be appropriate because it would be inconsistent with the objectives of denunciation and general deterrence.

6 Keyser J. sentenced the respondent to 18 months of incarceration and, pursuant to s. 259(2) of the Code, she made an order prohibiting the respondent from driving for a period of five years.

B. Manitoba Court of Appeal (1997), 123 Man. R. (2d) 107

7 The Court of Appeal allowed the appeal and substituted a conditional custodial sentence for the jail term. Helper J.A., writing for the court, contended that the sentencing judge had erred in her application of s. 742.1 by giving undue weight to the objective of denunciation. She explained that the recent amendment to s. 742.1 had not changed the fact that Parliament had identified the safety of the community as the primary consideration when deciding whether to impose a conditional sentence. Helper J.A. added that the principles of sentencing played a different role in the determination of whether to impose a conditional sentence than they did in determining the length of the sentence. At pp. 111-12, she stated:

> However, in s. 742.1(b), Parliament has directed the sentencing judge to look to the principles of sentencing only for the purpose of satisfying herself that there is consistency between those principles and a conditional sentence for a particular offender. The amendment does not direct the sentencing judge to consider individually each of the principles of sentencing and determine that each is consistent with the offender's serving his sentence in the community. The sentencing judge must consider the principles of sentencing globally. It would be contrary to Parliament's intent for the sentencing judge to single out any one factor and to give it substantial weight to the exclusion of the other listed factors when she is making a decision under s. 742.1(b).

8 According to Helper J.A., the sentencing judge's comments implied that a conditional sentence would never be appropriate for the offence of dangerous driving, even when the offender did not potentially endanger the community, because that offence required a large component of general deterrence. Helper J.A. found this to be an error, as it would have rendered s. 742.1 inoperable in the case of particular offences, contrary to Parliament's intention. She found that, in the instant appeal, the sentencing judge had failed to recognize that a conditional sentence had some denunciatory effect.

9 Helper J.A. concluded that generally, after the judge has attributed the appropriate weight to each relevant principle of sentencing, determined that a fit sentence would be less than two years and found that the offender would not be a danger to the community, a conditional sentence would be consistent with ss. 718 to 718.2.

III. Relevant Statutory Provisions

10 Criminal Code, R.S.C., 1985, c. C-46

> 718. The fundamental purpose of sentencing is to contribute, along with crime prevention initiatives, to respect for the law and the maintenance of a just, peaceful and safe society by imposing just sanctions that have one or more of the following

objectives:

(a) to denounce unlawful conduct;
(b) to deter the offender and other persons from committing offences; (c) to separate offenders from society, where necessary; (d) to assist in rehabilitating offenders; (e) to provide reparations for harm done to victims or to the community; and
(f) to promote a sense of responsibility in offenders, and acknowledgment of the harm done to victims and to the community.

718.1 A sentence must be proportionate to the gravity of the offence and the degree of responsibility of the offender.

718.2 A court that imposes a sentence shall also take into consideration the following principles:

(a) a sentence should be increased or reduced to account for any relevant aggravating or mitigating circumstances relating to the offence or the offender, and, without limiting the generality of the foregoing,

  (i) evidence that the offence was motivated by bias, prejudice or hate based on race, national or ethnic origin, language, colour, religion, sex, age, mental or physical disability, sexual orientation, or any other similar factor,
  (ii) evidence that the offender, in committing the offence, abused the offender's spouse or child,
  (iii) evidence that the offender, in committing the offence, abused a position of trust or authority in relation to the victim, or
  (iv) evidence that the offence was committed for the benefit of, at the direction of or in association with a criminal organization

shall be deemed to be aggravating circumstances;

(b) a sentence should be similar to sentences imposed on similar offenders for similar offences committed in similar circumstances;
(c) where consecutive sentences are imposed, the combined sentence should not be unduly long or harsh;
(d) an offender should not be deprived of liberty, if less restrictive sanctions may be appropriate in the circumstances; and
(e) all available sanctions other than imprisonment that are reasonable in the circumstances should be considered for all offenders, with particular attention to the circumstances of aboriginal offenders.

732.1 ...

(2) The court shall prescribe, as conditions of a probation order, that the offender do all of the following:

(a) keep the peace and be of good behaviour;

(b) appear before the court when required to do so by the court; and
(c) notify the court or the probation officer in advance of any change of name or address, and promptly notify the court or the probation officer of any change of employment or occupation.

(3) The court may prescribe, as additional conditions of a probation order, that the offender do one or more of the following:

(a) report to a probation officer

  (i) within two working days, or such longer period as the court directs, after the making of the probation order, and
  (ii) thereafter, when required by the probation officer and in the manner directed by the probation officer;

(b) remain within the jurisdiction of the court unless written permission to go outside that jurisdiction is obtained from the court or the probation officer;
(c) abstain from

  (i) the consumption of alcohol or other intoxicating substances, or
  (ii) the consumption of drugs except in accordance with a medical prescription;

(d) abstain from owning, possessing or carrying a weapon;
(e) provide for the support or care of dependants;
(f) perform up to 240 hours of community service over a period not exceeding eighteen months;
(g) if the offender agrees, and subject to the program director's acceptance of the offender, participate actively in a treatment program approved by the province;
(g.1) where the lieutenant governor in council of the province in which the probation order is made has established a program for curative treatment in relation to the consumption of alcohol or drugs, attend at a treatment facility, designated by the lieutenant governor in council of the province, for assessment and curative treatment in relation to the consumption by the offender of alcohol or drugs that is recommended pursuant to the program;
(g.2) where the lieutenant governor in council of the province in which the probation order is made has established a program governing the use of an alcohol ignition interlock device by an offender and if the offender agrees to participate in the program, comply with the program; and
(h) comply with such other reasonable conditions as the court considers desirable, subject to any regulations made under subsection 738(2), for protecting society and for facilitating the offender's successful reintegration into the community.

732.2 ...

(5) Where an offender who is bound by a probation order is convicted of an offence, including an offence under section 733.1, and

(a) the time within which an appeal may be taken against that conviction has expired and the offender has not taken an appeal,

(b) the offender has taken an appeal against that conviction and the appeal has been dismissed, or

(c) the offender has given written notice to the court that convicted the offender that the offender elects not to appeal the conviction or has abandoned the appeal, as the case may be,

in addition to any punishment that may be imposed for that offence, the court that made the probation order may, on application by the prosecutor, require the offender to appear before it and, after hearing the prosecutor and the offender,

(d) where the probation order was made under paragraph 731(1)(a), revoke the order and impose any sentence that could have been imposed if the passing of sentence had not been suspended, or

(e) make such changes to the optional conditions as the court deems desirable, or extend the period for which the order is to remain in force for such period, not exceeding one year, as the court deems desirable,

and the court shall thereupon endorse the probation order accordingly and, if it changes the optional conditions or extends the period for which the order is to remain in force, inform the offender of its action and give the offender a copy of the order so endorsed.

733.1 (1) An offender who is bound by a probation order and who, without reasonable excuse, fails or refuses to comply with that order is guilty of

(a) an indictable offence and is liable to imprisonment for a term not exceeding two years; or

(b) an offence punishable on summary conviction and is liable to imprisonment for a term not exceeding eighteen months, or to a fine not exceeding two thousand dollars, or both.

742.1 Where a person is convicted of an offence, except an offence that is punishable by a minimum term of imprisonment, and the court

(a) imposes a sentence of imprisonment of less than two years, and

(b) is satisfied that serving the sentence in the community would not endanger the safety of the community and would be consistent with the fundamental purpose and principles of sentencing set out in sections 718 to 718.2,

the court may, for the purpose of supervising the offender's behaviour in the community, order that the offender serve the sentence in the community, subject to the offender's complying with the conditions of a conditional sentence order made under section 742.3.

742.3 (1) The court shall prescribe, as conditions of a conditional sentence order, that the offender do all of the following:

(a) keep the peace and be of good behaviour;

(b) appear before the court when required to do so by the court;
(c) report to a supervisor

  (i) within two working days, or such longer period as the court directs, after the making of the conditional sentence order, and
  (ii) thereafter, when required by the supervisor and in the manner directed by the supervisor;

(d) remain within the jurisdiction of the court unless written permission to go outside that jurisdiction is obtained from the court or the supervisor; and
(e) notify the court or the supervisor in advance of any change of name or address, and promptly notify the court or the supervisor of any change of employment or occupation.

(2) The court may prescribe, as additional conditions of a conditional sentence order, that the offender do one or more of the following:

(a) abstain from

  (i) the consumption of alcohol or other intoxicating substances, or
  (ii) the consumption of drugs except in accordance with a medical prescription;

(b) abstain from owning, possessing or carrying a weapon;
(c) provide for the support or care of dependants;
(d) perform up to 240 hours of community service over a period not exceeding eighteen months;
(e) attend a treatment program approved by the province; and
(f) comply with such other reasonable conditions as the court considers desirable, subject to any regulations made under subsection 738(2), for securing the good conduct of the offender and for preventing a repetition by the offender of the same offence or the commission of other offences.

742.6 ...

(9) Where the court is satisfied, on a balance of probabilities, that the offender has without reasonable excuse, the proof of which lies on the offender, breached a condition of the conditional sentence order, the court may

(a) take no action;
(b) change the optional conditions;
(c) suspend the conditional sentence order and direct

  (i) that the offender serve in custody a portion of the unexpired sentence, and
  (ii) that the conditional sentence order resume on the offender's release from custody, either with or without changes to the optional conditions; or

(d) terminate the conditional sentence order and direct that the offender be committed to custody until the expiration of the sentence.

IV. Issues

11 This appeal concerns the proper interpretation and application of the conditional sentencing regime set out in s. 742.1 and subsequent sections of the Criminal Code.

12 Since it came into force on September 3, 1996, the conditional sentence has generated considerable debate. With the advent of s. 742.1, Parliament has clearly mandated that certain offenders who used to go to prison should now serve their sentences in the community. Section 742.1 makes a conditional sentence available to a subclass of non-dangerous offenders who, prior to the introduction of this new regime, would have been sentenced to a term of incarceration of less than two years for offences with no minimum term of imprisonment.

13 In my view, to address meaningfully the complex interpretive issues raised by this appeal, it is important to situate this new sentencing tool in the broader context of the comprehensive sentencing reforms enacted by Parliament in Bill C-41. I will also consider the nature of the conditional sentence, contrasting it with probationary measures and incarceration. Next, I will address particular interpretive issues posed by s. 742.1. I will first discuss the statutory prerequisites to the imposition of a conditional sentence. Thereafter, I will consider how courts should determine whether a conditional sentence is appropriate, assuming the prerequisites are satisfied. I conclude with some general comments on the deference to which trial judges are entitled in matters of sentencing and dispose of the case at hand in conformity with the principles outlined in these reasons.

V. Analysis

A. The 1996 Sentencing Reforms (Bill C-41)

14 In September 1996, Bill C-41 came into effect. It substantially reformed Part XXIII of the Code, and introduced, inter alia, an express statement of the purposes and principles of sentencing, provisions for alternative measures for adult offenders and a new type of sanction, the conditional sentence of imprisonment.

15 As my colleagues Cory and Iacobucci JJ. explained in R. v. Gladue, [1999] 1 S.C.R. 688, at para. 39, "[t]he enactment of the new Part XXIII was a watershed, marking the first codification and significant reform of sentencing principles in the history of Canadian criminal law". They noted two of Parliament's principal objectives in enacting this new legislation: (i) reducing the use of prison as a sanction, and (ii) expanding the use of restorative justice principles in sentencing (at para. 48).

(1) Reducing the Use of Prison as a Sanction

16 Bill C-41 is in large part a response to the problem of overincarceration in Canada. It was noted in Gladue, at para. 52, that Canada's incarceration rate of approximately 130 inmates per 100,000 population places it second or third highest among industrialized democracies. In their reasons, Cory and Iacobucci JJ. reviewed numerous studies that uniformly concluded that incarceration is costly, frequently unduly harsh and "ineffective, not only in relation to its purported rehabilitative goals, but also in relation to its broader public goals" (para. 54). See also Report of the Canadian Committee on Corrections, Toward Unity: Criminal Justice and Corrections (1969); Canadian Sentencing Commission, Sentencing Reform: A Canadian Approach (1987), at pp. xxiii-xxiv; Standing Committee on Justice and Solicitor General, Taking Responsibility (1988), at p. 75. Prison has been characterized by some as a finishing school for criminals and as ill-preparing them for reintegration into society: see generally Canadian Committee on Corrections, supra, at p. 314; Correctional Service of Canada, A Summary of

Analysis of Some Major Inquiries on Corrections -- 1938 to 1977 (1982), at p. iv. In Gladue, at para. 57, Cory and Iacobucci JJ. held:

> Thus, it may be seen that although imprisonment is intended to serve the traditional sentencing goals of separation, deterrence, denunciation, and rehabilitation, there is widespread consensus that imprisonment has not been successful in achieving some of these goals. Overincarceration is a long-standing problem that has been many times publicly acknowledged but never addressed in a systematic manner by Parliament. In recent years, compared to other countries, sentences of imprisonment in Canada have increased at an alarming rate. The 1996 sentencing reforms embodied in Part XXIII, and s. 718.2(e) in particular, must be understood as a reaction to the overuse of prison as a sanction, and must accordingly be given appropriate force as remedial provisions. [Emphasis added.]

17 Parliament has sought to give increased prominence to the principle of restraint in the use of prison as a sanction through the enactment of s. 718.2(d) and (e). Section 718.2(d) provides that "an offender should not be deprived of liberty, if less restrictive sanctions may be appropriate in the circumstances", while s. 718.2(e) provides that "all available sanctions other than imprisonment that are reasonable in the circumstances should be considered for all offenders, with particular attention to the circumstances of aboriginal offenders". Further evidence of Parliament's desire to lower the rate of incarceration comes from other provisions of Bill C-41: s. 718(c) qualifies the sentencing objective of separating offenders from society with the words "where necessary", thereby indicating that caution be exercised in sentencing offenders to prison; s. 734(2) imposes a duty on judges to undertake a means inquiry before imposing a fine, so as to decrease the number of offenders who are incarcerated for defaulting on payment of their fines; and of course, s. 742.1, which introduces the conditional sentence. In Gladue, at para. 40, the Court held that "[t]he creation of the conditional sentence suggests, on its face, a desire to lessen the use of incarceration".

(2) Expanding the Use of Restorative Justice Principles in Sentencing

18 Restorative justice is concerned with the restoration of the parties that are affected by the commission of an offence. Crime generally affects at least three parties: the victim, the community, and the offender. A restorative justice approach seeks to remedy the adverse effects of crime in a manner that addresses the needs of all parties involved. This is accomplished, in part, through the rehabilitation of the offender, reparations to the victim and to the community, and the promotion of a sense of responsibility in the offender and acknowledgment of the harm done to victims and to the community.

19 Canadian sentencing jurisprudence has traditionally focussed on the aims of denunciation, deterrence, separation, and rehabilitation, with rehabilitation a relative late-comer to the sentencing analysis: see Gladue, at para. 42. With the introduction of Bill C-41, however, Parliament has placed new emphasis upon the goals of restorative justice. Section 718 sets out the fundamental purpose of sentencing, as well as the various sentencing objectives that should be vindicated when sanctions are imposed. In Gladue, supra, Cory and Iacobucci JJ. stated (at para. 43):

> Clearly, s. 718 is, in part, a restatement of the basic sentencing aims, which are listed in paras. (a) through (d). What are new, though, are paras. (e) and (f), which along with para. (d) focus upon the restorative goals of repairing the harms suffered by individual victims and by the community as a whole, promoting a sense of responsibility and an acknowledgment of the harm caused on the part of the offender, and attempting to rehabilitate or heal the offender. The concept of restorative justice which underpins paras. (d), (e), and (f) is briefly discussed below, but as a general

> matter restorative justice involves some form of restitution and reintegration into the community. The need for offenders to take responsibility for their actions is central to the sentencing process... . Restorative sentencing goals do not usually correlate with the use of prison as a sanction. In our view, Parliament's choice to include (e) and (f) alongside the traditional sentencing goals must be understood as evidencing an intention to expand the parameters of the sentencing analysis for all offenders. [Emphasis added; citation omitted.]

20 Parliament has mandated that expanded use be made of restorative principles in sentencing as a result of the general failure of incarceration to rehabilitate offenders and reintegrate them into society. By placing a new emphasis on restorative principles, Parliament expects both to reduce the rate of incarceration and improve the effectiveness of sentencing. During the second reading of Bill C-41 on September 20, 1994 (House of Commons Debates, vol. IV, 1st Sess., 35th Parl., at p. 5873), Minister of Justice Allan Rock made the following statements:

> A general principle that runs throughout Bill C-41 is that jails should be reserved for those who should be there. Alternatives should be put in place for those who commits offences but who do not need or merit incarceration.
>
> ...
>
> Jails and prisons will be there for those who need them, for those who should be punished in that way or separated from society... . [T]his bill creates an environment which encourages community sanctions and the rehabilitation of offenders together with reparation to victims and promoting in criminals a sense of accountability for what they have done.
>
> It is not simply by being more harsh that we will achieve more effective criminal justice. We must use our scarce resources wisely.

B. The Nature of the Conditional Sentence

21 The conditional sentence was specifically enacted as a new sanction designed to achieve both of Parliament's objectives. The conditional sentence is a meaningful alternative to incarceration for less serious and non-dangerous offenders. The offenders who meet the criteria of s. 742.1 will serve a sentence under strict surveillance in the community instead of going to prison. These offenders' liberty will be constrained by conditions to be attached to the sentence, as set out in s. 742.3 of the Code. In case of breach of conditions, the offender will be brought back before a judge, pursuant to s. 742.6. If an offender cannot provide a reasonable excuse for breaching the conditions of his or her sentence, the judge may order him or her to serve the remainder of the sentence in jail, as it was intended by Parliament that there be a real threat of incarceration to increase compliance with the conditions of the sentence.

22 The conditional sentence incorporates some elements of non-custodial measures and some others of incarceration. Because it is served in the community, it will generally be more effective than incarceration at achieving the restorative objectives of rehabilitation, reparations to the victim and community, and the promotion of a sense of responsibility in the offender. However, it is also a punitive sanction capable of achieving the objectives of denunciation and deterrence. It is this punitive aspect that distinguishes the conditional sentence from probation, and it is to this issue that I now turn.

(1) Comparing Conditional Sentences with Probation

23 There has been some confusion among members of the judiciary and the public alike about the difference between a conditional sentence and a suspended sentence with probation. This confusion is understandable, as the statutory provisions regarding conditions to be attached to conditional sentences (s. 742.3) and probation orders (s. 732.1) are very similar. Notwithstanding these similarities, there is an important distinction between the two. While a suspended sentence with probation is primarily a rehabilitative sentencing tool, the evidence suggests that Parliament intended a conditional sentence to address both punitive and rehabilitative objectives.

(a) A Comparative Reading of the Provisions

24 A comparative reading of the provisions governing conditional sentences and probation orders reveals three differences. First, a probation order includes only three compulsory conditions -- to keep the peace and be of good behaviour, appear before the court when required, and notify the court or probation officer of any change in employment or address -- whereas there are five such conditions in the case of a conditional sentence. The two additional compulsory conditions of a conditional sentence -- to report to a supervisor and remain within the jurisdiction unless permission is granted to leave -- are listed as optional conditions under a probation order.

25 The second difference concerns the power of the judge to order the offender to undergo treatment. Under a conditional sentence, the sentencing judge can order the offender to attend a treatment program, regardless of whether the offender consents. Under a probation order, the judge can only impose a treatment order with the consent of the offender (with the exception of drug or alcohol addiction programs since the 1999 amendment to s. 732.1 (S.C. 1999, c. 32, s. 6)). In practice, however, this difference is not very significant, since it is unlikely that an offender faced with the choice between imprisonment and a suspended sentence with treatment as a condition of probation would refuse to consent to treatment.

26 The third difference is in the wording of the residual clauses of the provisions governing the imposition of optional conditions. In the case of a conditional sentence, s. 742.3(2)(f) provides that the court may order that the offender comply with such other reasonable conditions as the court considers desirable "for securing the good conduct of the offender and for preventing a repetition by the offender of the same offence or the commission of other offences". By contrast, s. 732.1(3)(h) provides that the court may impose such other reasonable conditions of probation "for protecting society and for facilitating the offender's successful reintegration into the community".

27 On their face, these three differences do not suggest that a conditional sentence is more punitive than a suspended sentence with probation. Moreover, the penalty for breach of probation is potentially more severe than that for breach of a conditional sentence. Pursuant to s. 733.1(1), breach of probation constitutes a new offence, punishable by up to two years imprisonment, while a breach of condition does not constitute a new offence per se. The maximum penalties are also different. In the case of a breach of probation, the offender is subject to the revocation of the probation order and can be sentenced for the original offence (in cases where a suspended sentence was rendered): see s. 732.2(5). By contrast, in the case of breaches of conditional sentences, the maximum punishment available is incarceration for the time remaining of the original sentence (s. 742.6(9)). Presumably, if a conditional sentence is more onerous than probation, the consequences of breaching a condition should be more onerous as well.

(b) Conditional Sentences Must Be More Punitive Than Probation

28 Despite the similarities between the provisions and the fact that the penalty for breach of probation is potentially more severe than for breach of a conditional sentence, there are strong indications that Parliament intended the conditional sentence to be more punitive than probation. It is a well accepted

principle of statutory interpretation that no legislative provision should be interpreted so as to render it mere surplusage. It would be absurd if Parliament intended conditional sentences to amount merely to probation under a different name. While this argument is clearly not dispositive, it suggests that Parliament intended there to be a meaningful distinction between the two sanctions. I will now consider more specific arguments in support of this position.

29 The conditional sentence is defined in the Code as a sentence of imprisonment. The heading of s. 742 reads "Conditional Sentence of Imprisonment". Furthermore, s. 742.1(a) requires the court to impose a sentence of imprisonment of less than two years before considering whether the sentence can be served in the community subject to the appropriate conditions. Parliament intended imprisonment, in the form of incarceration, to be more punitive than probation, as it is far more restrictive of the offender's liberty. Since a conditional sentence is, at least notionally, a sentence of imprisonment, it follows that it too should be interpreted as more punitive than probation.

30 On a related note, with the enactment of s. 742.1, Parliament has mandated that certain non-dangerous offenders who would otherwise have gone to jail for up to two years now serve their sentences in the community. If a conditional sentence is not distinguished from probation, then these offenders will receive what are effectively considerably less onerous probation orders instead of jail terms. Such lenient sentences would not provide sufficient denunciation and deterrence, nor would they be accepted by the public. Section 718 provides that the fundamental purpose of sentencing is "to contribute ... to respect for the law and the maintenance of a just, peaceful and safe society". Inadequate sanctions undermine respect for the law. Accordingly, it is important to distinguish a conditional sentence from probation by way of the use of punitive conditions.

31 Earlier I drew attention to a subtle difference between the residual clauses in the provisions governing the imposition of optional conditions of probation orders and conditional sentences. While the difference between the two residual clauses is subtle, it is also significant. In order to appreciate this difference, it is necessary to consider the case law and practice that has developed with respect to probation.

32 Probation has traditionally been viewed as a rehabilitative sentencing tool. Recently, the rehabilitative nature of the probation order was explained by the Saskatchewan Court of Appeal in R. v. Taylor (1997), 122 C.C.C. (3d) 376. Bayda C.J.S. wrote, at p. 394:

> Apart from the wording of the provision, the innate character of a probation order is such that it seeks to influence the future behaviour of the offender. More specifically, it seeks to secure "the good conduct" of the offender and to deter him from committing other offences. It does not particularly seek to reflect the seriousness of the offence or the offender's degree of culpability. Nor does it particularly seek to fill the need for denunciation of the offence or the general deterrence of others to commit the same or other offences. Depending upon the specific conditions of the order there may well be a punitive aspect to a probation order but punishment is not the dominant or an inherent purpose. It is perhaps not even a secondary purpose but is more in the nature of a consequence of an offender's compliance with one or more of the specific conditions with which he or she may find it hard to comply. [Emphasis added.]

33 Many appellate courts have struck out conditions of probation that were imposed to punish rather than rehabilitate the offender: see R. v. Ziatas (1973), 13 C.C.C. (2d) 287 (Ont. C.A.), at p. 288; R. v. Caja (1977), 36 C.C.C. (2d) 401 (Ont. C.A.), at pp. 402-3; R. v. Lavender (1981), 59 C.C.C. (2d) 551 (B.C.C.A.), at pp. 552-53, and R. v. L. (1986), 50 C.R. (3d) 398 (Alta. C.A.), at pp. 399-400. The impugned terms of probation in these cases were imposed pursuant to a residual clause in force at the time whose wording was virtually identical to that presently used in s. 742.3(2)(f).

34 Despite the virtual identity in the wording of s. 742.3(2)(f) and the old residual clause applicable to probation orders, it would be a mistake to conclude that punitive conditions cannot now be imposed under s. 742.3(2)(f). Parliament amended the residual clause for probation, s. 732.1(3)(h), to read "for protecting society and for facilitating the offender's successful reintegration into the community" (emphasis added). It did so to make clear the rehabilitative purpose of probation and to distinguish s. 742.3(2)(f) from s. 732.1(3)(h). The wording used in s. 742.3(2)(f) does not focus principally on the rehabilitation and reintegration of the offender. If s. 742.3(2)(f) were interpreted as precluding punitive conditions, it would frustrate Parliament's intention in distinguishing the two forms of sentence. Parliament would not have distinguished them if it intended both clauses to serve the same purpose.

35 In light of the foregoing, it is clear that Parliament intended a conditional sentence to be more punitive than a suspended sentence with probation, notwithstanding the similarities between the two sanctions in respect of their rehabilitative purposes. I agree wholeheartedly with Vancise J.A., who, dissenting in R. v. McDonald (1997), 113 C.C.C. (3d) 418 (Sask. C.A.), stated, at p. 443, that conditional sentences were designed to "permit the accused to avoid imprisonment but not to avoid punishment".

36 Accordingly, conditional sentences should generally include punitive conditions that are restrictive of the offender's liberty. Conditions such as house arrest or strict curfews should be the norm, not the exception. As the Minister of Justice said during the second reading of Bill C-41 (House of Commons Debates, supra, at p. 5873), "[t]his sanction is obviously aimed at offenders who would otherwise be in jail but who could be in the community under tight controls" (emphasis added).

37 There must be a reason for failing to impose punitive conditions when a conditional sentence order is made. Sentencing judges should always be mindful of the fact that conditional sentences are only to be imposed on offenders who would otherwise have been sent to jail. If the judge is of the opinion that punitive conditions are unnecessary, then probation, rather than a conditional sentence, is most likely the appropriate disposition.

38 The punitive nature of the conditional sentence should also inform the treatment of breaches of conditions. As I have already discussed, the maximum penalty for breach of probation is potentially more severe than that for breach of a conditional sentence. In practice, however, breaches of conditional sentences may be punished more severely than breaches of probation. Without commenting on the constitutionality of these provisions, I note that breaches of conditional sentence need only be proved on a balance of probabilities, pursuant to s. 742.6(9), whereas breaches of probation must be proved beyond a reasonable doubt.

39 More importantly, where an offender breaches a condition without reasonable excuse, there should be a presumption that the offender serve the remainder of his or her sentence in jail. This constant threat of incarceration will help to ensure that the offender complies with the conditions imposed: see R. v. Brady (1998), 121 C.C.C. (3d) 504 (Alta. C.A.); J. V. Roberts, "Conditional Sentencing: Sword of Damocles or Pandora's Box?" (1997), 2 Can. Crim. L. Rev. 183. It also assists in distinguishing the conditional sentence from probation by making the consequences of a breach of condition more severe.

(2) Conditional Sentences and Incarceration

40 Although a conditional sentence is by statutory definition a sentence of imprisonment, this Court, in R. v. Shropshire, [1995] 4 S.C.R. 227, at para. 21, recognized that there "is a very significant

difference between being behind bars and functioning within society while on conditional release". See also Cunningham v. Canada, [1993] 2 S.C.R. 143, at p. 150, per McLachlin J. These comments are equally applicable to the conditional sentence. Indeed, offenders serving a conditional sentence in the community are only partially deprived of their freedom. Even if their liberty is restricted by the conditions attached to their sentence, they are not confined to an institution and they can continue to attend to their normal employment or educational endeavours. They are not deprived of their private life to the same extent. Nor are they subject to a regimented schedule or an institutional diet.

41 This is not to say that the conditional sentence is a lenient punishment or that it does not provide significant denunciation and deterrence, or that a conditional sentence can never be as harsh as incarceration. As this Court stated in Gladue, supra, at para. 72:

> ... in our view a sentence focussed on restorative justice is not necessarily a "lighter" punishment. Some proponents of restorative justice argue that when it is combined with probationary conditions it may in some circumstances impose a greater burden on the offender than a custodial sentence.

A conditional sentence may be as onerous as, or perhaps even more onerous than, a jail term, particularly in circumstances where the offender is forced to take responsibility for his or her actions and make reparations to both the victim and the community, all the while living in the community under tight controls.

42 Moreover, the conditional sentence is not subject to reduction through parole. This would seem to follow from s. 112(1) of the Corrections and Conditional Release Act, S.C. 1992, c. 20, which gives the provincial parole board jurisdiction in respect of the parole of offenders "serving sentences of imprisonment in provincial correctional facilities" (R. v. Wismayer (1997), 115 C.C.C. (3d) 18 (Ont. C.A.), at p. 33).

43 I would add that the fact that a conditional sentence cannot be reduced through parole does not in itself lead to the conclusion that as a general matter a conditional sentence is as onerous as or even more onerous than a jail term of equivalent duration. There is no parole simply because the offender is never actually incarcerated and he or she does not need to be reintegrated into society. But even when an offender is released from custody on parole, the original sentence continues in force. As I stated in M. (C.A.), supra, at para. 62:

> In short, the history, structure and existing practice of the conditional release system collectively indicate that a grant of parole represents a change in the conditions under which a judicial sentence must be served, rather than a reduction of the judicial sentence itself... . But even though the conditions of incarceration are subject to change through a grant of parole to the offender's benefit, the offender's sentence continues in full effect. The offender remains under the strict control of the parole system, and the offender's liberty remains significantly curtailed for the full duration of the offender's numerical or life sentence. [Emphasis in original.]

The parolee has to serve the final portion of his or her sentence under conditions similar to those that can be imposed under a conditional sentence, perhaps even under stricter conditions, as the parolee can be assigned to a "community-based residential facility": see s. 133 of the Corrections and Conditional Release Act and s. 161 of the Corrections and Conditional Release Regulations, SOR92-620.

44 In light of these observations, a conditional sentence, even with stringent conditions, will usually be a more lenient sentence than a jail term of equivalent duration: see also Gagnon v. La Reine, [1998] R.J.Q. 2636 (C.A.), at p. 2645; Brady, supra, at paras. 36 and 48 to 50. The fact that incarceration is a threatened punishment for those who breach their conditions provides further support for this conclusion. In order for incarceration to serve as a punishment for breach of a conditional sentence, logically it must be more onerous than a conditional sentence.

C. Application of Section 742.1 of the Criminal Code

45 For convenience, I will reproduce here s. 742.1:

> 742.1 Where a person is convicted of an offence, except an offence that is punishable by a minimum term of imprisonment, and the court
>
> (a) imposes a sentence of imprisonment of less than two years, and
> (b) is satisfied that serving the sentence in the community would not endanger the safety of the community and would be consistent with the fundamental purpose and principles of sentencing set out in sections 718 to 718.2,
>
> the court may, for the purpose of supervising the offender's behaviour in the community, order that the offender serve the sentence in the community, subject to the offender's complying with the conditions of a conditional sentence order made under section 742.3.

46 This provision lists four criteria that a court must consider before deciding to impose a conditional sentence:

(1) the offender must be convicted of an offence that is not punishable by a minimum term of imprisonment;
(2) the court must impose a term of imprisonment of less than two years;
(3) the safety of the community would not be endangered by the offender serving the sentence in the community; and
(4) a conditional sentence would be consistent with the fundamental purpose and principles of sentencing set out in ss. 718 to 718.2.

47 In my view, the first three criteria are prerequisites to any conditional sentence. These prerequisites answer the question of whether or not a conditional sentence is possible in the circumstances. Once they are met, the next question is whether a conditional sentence is appropriate. This decision turns upon a consideration of the fundamental purpose and principles of sentencing set out in ss. 718 to 718.2. I will discuss each of these elements in turn.

(1) The Offender Must be Convicted of an Offence That Is Not Punishable by a Minimum Term of Imprisonment

48 This prerequisite is straightforward. The offence for which the offender was convicted must not be punishable by a minimum term of imprisonment. Offences with a minimum term of imprisonment are the only statutory exclusions from the conditional sentencing regime.

(2) The Court Must Impose a Term of Imprisonment of Less than Two Years

49 Parliament intended that a conditional sentence be considered only for those offenders who would have otherwise received a sentence of imprisonment of less than two years. There is some controversy as to whether this means that the judge must actually impose a term of imprisonment of a fixed duration before considering the possibility of a conditional sentence. Far from addressing purely methodological concerns, this question carries implications as to the role of ss. 718 to 718.2 in the determination of the appropriate sentence, the duration of the sentence, its venue and other modalities.

50 A literal reading of s. 742.1(a) suggests that the decision to impose a conditional sentence should be made in two distinct stages. In the first stage, the judge would have to decide the appropriate sentence according to the general purposes and principles of sentencing (now set out in ss. 718 to 718.2). Having found that a term of imprisonment of less than two years is warranted, the judge would then, in a second stage, decide whether this same term should be served in the community pursuant to s. 742.1. At first sight, since Parliament said: "and the court (a) imposes a sentence of imprisonment of less than two years", it seems that the sentencing judge must first impose a term of imprisonment of a fixed duration before contemplating the possibility that this term be served in the community.

51 This two-step approach was endorsed by the Manitoba Court of Appeal in the present appeal. However, this literal reading of s. 742.1 and the two-step approach it implies introduce a rigidity which is both unworkable and undesirable in practice.

(a) Duration and Venue Cannot Be Separated

52 This two-step process does not correspond to the reality of sentencing. In practice, the determination of a term of imprisonment is necessarily intertwined with the decision of where the offender will serve the sentence. A judge does not impose a fixed sentence of "x months" in the abstract, without having in mind where that sentence will be served (see Brady, supra, at para. 86; R. v. Pierce (1997), 114 C.C.C. (3d) 23 (Ont. C.A.), at p. 39; R. v. Ursel (1997), 96 B.C.A.C. 241, at p. 284 (per Ryan J.A.) and pp. 291-92 (per Rowles J.A.)). Furthermore, when a conditional sentence is chosen, its duration will depend on the type of conditions imposed. Therefore, the duration of the sentence should not be determined separately from the determination of its venue.

(b) "Penalogical Paradox"

53 There is a contradiction embedded in this rigid two-step process. After having applied ss. 718 to 718.2 in the first stage to conclude that the appropriate sentence is a term of imprisonment of a fixed duration (in all cases less than two years), the judge would then have to decide if serving the same sentence in the community is still consistent with the fundamental purpose and principles of sentencing set out in ss. 718 to 718.2, as required by s. 742.1(b). It is unrealistic to believe that a judge would consider the objectives and principles twice or make a clear distinction in his or her mind between the application of ss. 718 to 718.2 in the first stage and in the second stage. Even if this could be done, it could lead to a "penalogical paradox", as described by J. Gemmell in, "The New Conditional Sentencing Regime" (1997), 39 Crim. L.Q. 334, at p. 337:

> ... the judge must first determine that imprisonment is the only reasonable sanction in the circumstances then decide whether the offender should nevertheless serve that sentence in the community. The decision to impose a conditional sentence is almost a kind of reductio ad absurdum of the original decision that called for imprisonment. [Footnote omitted.]

54 This second step of the analytical process would effectively compromise the principles of sentencing that led to the imposition of a sentence of imprisonment in the first place. For instance, the principle of proportionality, set out in s. 718.1 as the fundamental principle of sentencing, directs that all sentences must be proportional to the gravity of the offence and the degree of responsibility of the offender. When a judge -- in the first stage decides that a term of imprisonment of "x months" is appropriate, it means that this sentence is proportional. If the sentencing judge decides -- in the second stage -- that the same term can be served in the community, it is possible that the sentence is no longer proportional to the gravity of the offence and the responsibility of the offender, since a conditional sentence will generally be more lenient than a jail term of equivalent duration. Thus, such a two-step approach introduces a rigidity in the sentencing process that could lead to an unfit sentence.

(c) A Purposive Interpretation of Section 742.1(a)

55 These problems can be addressed by a purposive interpretation of s. 742.1(a). For the reasons discussed above, the requirement that the court "imposes a sentence of imprisonment of less than two years" could not have been intended to impose on judges a rigid two-step process. Rather, it was included to identify the type of offenders who could be entitled to a conditional sentence. At one end of the range, Parliament denied the possibility of a conditional sentence for offenders who should receive a penitentiary term. At the other end, Parliament intended to ensure that offenders who were entitled to a more lenient community measure -- such as a suspended sentence with probation -- did not receive a conditional sentence, a harsher sanction in this legislative scheme.

56 Section 742.1(a), when read in conjunction with ss. 718.2(d) and 718.2(e), cautions sentencing judges against "widening the net" of the conditional sentencing regime by imposing conditional sentences on offenders who would otherwise have received a non-custodial disposition (Gagnon, supra, at p. 2645; McDonald, supra, at pp. 437-39). As Rosenberg J.A. puts it in Wismayer, supra, at p. 42:

> Parliament's goal of reducing the prison population of non-violent offenders and increased use of community sanctions will be frustrated if the courts refuse to use the conditional sentence order for offences that normally attract a jail sentence and resort to the conditional sentence only for offences that previously would have attracted non-custodial dispositions.

Erroneously imposing conditional sentences could undermine Parliament's objective of reducing incarceration for less serious offenders.

57 These concerns are illustrated by the English experience with a similar sentence called a "suspended sentence". As Parker L.C.J. explained, writing for the Court of Appeal (Criminal Division) in R. v. O'Keefe (1968), 53 Cr. App. R. 91, at pp. 94-95:

> This Court would like to say as emphatically as they can that suspended sentences should not be given when, but for the power to give a suspended sentence, a probation order was the proper order to make. After all, a suspended sentence is a sentence of imprisonment... .
>
> Therefore, it seems to the Court that before one gets to a suspended sentence at all, a court must go through the process of eliminating other possible courses such as absolute discharge, conditional discharge, probation order, fine, and then say to itself: this is a case for imprisonment, and the final question, it being a case for imprisonment: is immediate imprisonment required, or can I give a suspended sentence?

58 A similar approach should be used by Canadian courts. Hence, a purposive interpretation of s. 742.1(a) does not dictate a rigid two-step approach in which the judge would first have to impose a term of imprisonment of a fixed duration and then decide if that fixed term of imprisonment can be served in the community. In my view, the requirement that the court must impose a sentence of imprisonment of less than two years can be fulfilled by a preliminary determination of the appropriate range of available

sentences. Thus, the approach I suggest still requires the judge to proceed in two stages. However, the judge need not impose a term of imprisonment of a fixed duration at the first stage of the analysis. Rather, at this stage, the judge simply has to exclude two possibilities: (a) probationary measures; and (b) a penitentiary term. If either of these sentences is appropriate, then a conditional sentence should not be imposed.

59 In making this preliminary determination, the judge need only consider the fundamental purpose and principles of sentencing set out in ss. 718 to 718.2 to the extent necessary to narrow the range of sentence for the offender. The submissions of the parties, although not binding, may prove helpful in this regard. For example, both parties may agree that the appropriate range of sentence is a term of imprisonment of less than two years.

60 Once that preliminary determination is made, and assuming the other statutory prerequisites are met, the judge should then proceed to the second stage of the analysis: determining whether a conditional sentence would be consistent with the fundamental purpose and principles of sentencing set out in ss. 718 to 718.2. Unlike the first stage, the principles of sentencing are now considered comprehensively. Further, it is at the second stage that the duration and venue of the sentence should be determined, and, if a conditional sentence, the conditions to be imposed.

61 This purposive interpretation of s. 742.1(a) avoids the pitfalls of the literal interpretation discussed above, while at all times taking into account the principles and objectives of sentencing. As I stressed in M. (C.A.), supra, at para. 82.

> In the final analysis, the overarching duty of a sentencing judge is to draw upon all the legitimate principles of sentencing to determine a "just and appropriate" sentence which reflects the gravity of the offence committed and the moral blameworthiness of the offender.

(3) The Safety of the Community Would Not Be Endangered by the Offender Serving the Sentence in the Community

62 This criterion, set out in s. 742.1(b), has generated wide discussion in courts and among authors. I intend to discuss the following issues:

(a) Is safety of the community a prerequisite to any conditional sentence?
(b) Does "safety of the community" refer only to the threat posed by the specific offender?
(c) How should courts evaluate danger to the community?
(d) Is risk of economic prejudice to be considered in assessing danger to the community?
(a) A Prerequisite to Any Conditional Sentence

63 As a prerequisite to any conditional sentence, the sentencing judge must be satisfied that having the offender serve the sentence in the community would not endanger its safety: see Brady, supra, at para. 58; R. v. Maheu, [1997] R.J.Q. 410, 116 C.C.C. (3d) 361 (C.A.), at p. 368 C.C.C.; Gagnon, supra, at p. 2641; Pierce, supra, at p. 39; Ursel, supra, at pp. 284-86 (per Ryan J.A.). If the sentencing judge is not satisfied that the safety of the community can be preserved, a conditional sentence must never be imposed.

64 With respect, the Manitoba Court of Appeal in the case before us erred in concluding that safety of the community was the primary consideration in the decision to impose a conditional sentence. As the Alberta Court of Appeal in Brady, supra, at para. 58, stated:

So to suggest that danger is the primary consideration is tendentious. It wrongly implies that absence of danger trumps or has paramountcy over other sentencing principles. Either the offender meets the no-danger threshold, or he does not. If he does, this consideration is spent and the focus must then properly be on the other sentencing principles and objectives.

65 I agree. It is only once the judge is satisfied that the safety of the community would not be endangered, in the sense explained in paras. 66 to 76 below, that he or she can examine whether a conditional sentence "would be consistent with the fundamental purpose and principles of sentencing set out in sections 718 to 718.2". In other words, rather than being an overarching consideration in the process of determining whether a conditional sentence is appropriate, the criterion of safety of the community should be viewed as a condition precedent to the assessment of whether a conditional sentence would be a fit and proper sanction in the circumstances.

(b) "Safety of the Community" Refers to the Threat Posed by the Specific Offender

66 The issue here is whether "safety of the community" refers only to the threat posed by the specific offender or whether it also extends to the broader risk of undermining respect for the law. The proponents of the broader interpretation argue that, in certain cases where a conditional sentence could be imposed, it would be perceived that wrongdoers are receiving lenient sentences, thereby insufficiently deterring those who may be inclined to engage in similar acts of wrongdoing, and, in turn, endangering the safety of the community.

67 Leaving aside the fact that a properly crafted conditional sentence can also achieve the objectives of general deterrence and denunciation, I think the debate has been rendered largely academic in light of an amendment to s. 742.1(b) (S.C. 1997, c. 18, s. 107.1) which clarified that courts must take into consideration the fundamental purpose and principles of sentencing set out in ss. 718 to 718.2 in deciding whether to impose a conditional sentence. This ensures that objectives such as denunciation and deterrence will be dealt with in the decision to impose a conditional sentence. Since these factors will be taken into account later in the analysis, there is no need to include them in the consideration of the safety of the community.

68 In my view, the focus of the analysis at this point should clearly be on the risk posed by the individual offender while serving his sentence in the community. I would note that a majority of appellate courts have adopted an interpretation of the criterion referring only to the threat posed by the specific offender: see Gagnon, supra, at pp. 2640-41 (per Fish J.A.); R. v. Parker (1997), 116 C.C.C. (3d) 236 (N.S.C.A.), at pp. 247-48; Ursel, supra, at p. 260; R. v. Horvath, [1997] 8 W.W.R. 357 (Sask. C.A.), at p. 374; Brady, supra, at paras. 60-61; Wismayer, supra, at p. 44.

(c) How Should Courts Evaluate Danger to the Community?

69 In my opinion, to assess the danger to the community posed by the offender while serving his or her sentence in the community, two factors must be taken into account: (1) the risk of the offender re-offending; and (2) the gravity of the damage that could ensue in the event of re-offence. If the judge finds that there is a real risk of re-offence, incarceration should be imposed. Of course, there is always some risk that an offender may re-offend. If the judge thinks this risk is minimal, the gravity of the damage that could follow were the offender to re-offend should also be taken into consideration. In certain cases, the minimal risk of re-offending will be offset by the possibility of a great prejudice, thereby precluding a conditional sentence.

(i) Risk of Re-offence

70 A variety of factors will be relevant in assessing the risk of re-offence. In Brady, supra, at paras. 117-27, Fraser C.J.A. suggested that consideration be given to whether the offender has previously complied with court orders and, more generally, to whether the offender has a criminal record that suggests that the offender will not abide by the conditional sentence. Rousseau-Houle J.A. in Maheu, supra, at p. 374 C.C.C. enumerated additional factors which may be of relevance:

> [TRANSLATION] ... 1) the nature of the offence, 2) the relevant circumstances of the offence, which can put in issue prior and subsequent incidents, 3) the degree of participation of the accused, 4) the relationship of the accused with the victim, 5) the profile of the accused, that is, his [or her] occupation, lifestyle, criminal record, family situation, mental state, 6) his [or her] conduct following the commission of the offence, 7) the danger which the interim release of the accused represents for the community, notably that part of the community affected by the matter.

71 This list is instructive, but should not be considered exhaustive. The risk that a particular offender poses to the community must be assessed in each case, on its own facts. Moreover, the factors outlined above should not be applied mechanically. As Fraser C.J.A. held in Brady, supra, at para. 124:

> Forgetting a court date once ten years ago does not automatically bar an offender from any future conditional sentence. Nor does turning up for his trial guarantee an offender a conditional sentence. The sentencing judge must of course look at all aspects of these previous disobediences of courts. That includes frequency, age, maturity, recency, seriousness of disobedience and surrounding circumstances.

72 The risk of re-offence should also be assessed in light of the conditions attached to the sentence. Where an offender might pose some risk of endangering the safety of the community, it is possible that this risk be reduced to a minimal one by the imposition of appropriate conditions to the sentence: see Wismayer, supra, at p. 32; Brady, supra, at para. 62; Maheu, supra, at p. 374 C.C.C. Indeed, this is contemplated by s. 742.3(2)(f), which allows the court to include as optional conditions "such other reasonable conditions as the court considers desirable ... for securing the good conduct of the offender and for preventing a repetition by the offender of the same offence or the commission of other offences". For example, a judge may wish to impose a conditional sentence with a treatment order on an offender with a drug addiction, notwithstanding the fact that the offender has a lengthy criminal record linked to this addiction, provided the judge is confident that there is a good chance of rehabilitation and that the level of supervision will be sufficient to ensure that the offender complies with the sentence.

73 This last point concerning the level of supervision in the community must be underscored. As the Alberta Court of Appeal stressed in Brady, supra, at para. 135:

> A conditional sentence drafted in the abstract without knowledge of what actual supervision and institutions and programs are available and suitable for this offender is often worse than tokenism: it is a sham.

Hence, the judge must know or be made aware of the supervision available in the community by the supervision officer or by counsel. If the level of supervision available in the community is not sufficient to ensure safety of the community, the judge should impose a sentence of incarceration.

(ii) Gravity of the Damage in the Event of Re-offence

74 Once the judge finds that the risk of recidivism is minimal, the second factor to consider is the gravity of the potential damage in case of re-offence. Particularly in the case of violent offenders, a small risk of very harmful future crime may well warrant a conclusion that the prerequisite is not met: see Brady, supra, at para. 63.

(d) Risk of Economic Harm Can Be Taken Into Consideration

75 The meaning of the phrase "would not endanger the safety of the community" should not be restricted to a consideration of the danger to physical or psychological safety of persons. In my view, this part of s. 742.1(b) cannot be given this narrow meaning. As Finch J.A. stated in Ursel, supra, at p. 264 (dissenting in part but endorsed by the majority on this issue, at p. 287):

> I would not give to this phrase the restricted meaning for which the defence contends. Members of our community have a reasonable expectation of safety not only in respect of their persons, but in respect as well of their property and financial resources. When homes are broken into, motor-vehicles are stolen, employers are defrauded of monies, or financial papers are forged, the safety of the community is, in my view endangered. We go to considerable lengths to protect and secure ourselves against the losses that may result from these sorts of crimes, and I think most ordinary citizens would regard themselves as threatened or endangered where their property or financial resources are exposed to the risk of loss.

76 I agree with this reasoning. The phrase "would not endanger the safety of the community" should be construed broadly, and include the risk of any criminal activity. Such a broad interpretation encompasses the risk of economic harm.

(4) Consistent with the Fundamental Purpose and Principles of Sentencing Set Out in Sections 718 to 718.2

77 Once the sentencing judge has found the offender guilty of an offence for which there is no minimum term of imprisonment, has rejected both a probationary sentence and a penitentiary term as inappropriate, and is satisfied that the offender would not endanger the community, the judge must then consider whether a conditional sentence would be consistent with the fundamental purpose and principles of sentencing set out in ss. 718 to 718.2.

78 A consideration of the principles set out in ss. 718 to 718.2 will determine whether the offender should serve his or her sentence in the community or in jail. The sentencing principles also inform the determination of the duration of these sentences and, if a conditional sentence, the nature of the conditions to be imposed.

(a) Offences Presumptively Excluded from the Conditional Sentencing Regime?

79 Section 742.1 does not exclude any offences from the conditional sentencing regime except those with a minimum term of imprisonment. Parliament could have easily excluded specific offences in addition to those with a mandatory minimum term of imprisonment but chose not to. As Rosenberg J.A. held in Wismayer, supra, at p. 31:

> Parliament clearly envisaged that a conditional sentence would be available even in cases of crimes of violence that are not punishable by a minimum term of imprisonment. Thus, s. 742.2 requires the court, before imposing a conditional

> sentence, to consider whether a firearms prohibition under s. 100 of the Criminal Code is applicable. Such orders may only be imposed for indictable offences having a maximum sentence of ten years or more "in the commission of which violence against a person is used, threatened, or attempted" (s. 100(1)) and for certain weapons and drug offences (s. 100(2)).

Thus, a conditional sentence is available in principle for all offences in which the statutory prerequisites are satisfied.

80 Several parties in the appeals before us argued that the fundamental purpose and principles of sentencing support a presumption against conditional sentences for certain offences. The Attorney General of Canada and the Attorney General for Ontario submitted that a conditional sentence would rarely be appropriate for offences such as: sexual offences against children; aggravated sexual assault; manslaughter; serious fraud or theft; serious morality offences; impaired or dangerous driving causing death or bodily harm; and trafficking or possession of certain narcotics. They submitted that this followed from the principle of proportionality as well as from a consideration of the objectives of denunciation and deterrence. A number of appellate court decisions support this position.

81 In my view, while the gravity of such offences is clearly relevant to determining whether a conditional sentence is appropriate in the circumstances, it would be both unwise and unnecessary to establish judicially created presumptions that conditional sentences are inappropriate for specific offences. Offence-specific presumptions introduce unwarranted rigidity in the determination of whether a conditional sentence is a just and appropriate sanction. Such presumptions do not accord with the principle of proportionality set out in s. 718.1 and the value of individualization in sentencing, nor are they necessary to achieve the important objectives of uniformity and consistency in the use of conditional sentences.

82 This Court has held on a number of occasions that sentencing is an individualized process, in which the trial judge has considerable discretion in fashioning a fit sentence. The rationale behind this approach stems from the principle of proportionality, the fundamental principle of sentencing, which provides that a sentence must be proportional to the gravity of the offence and the degree of responsibility of the offender. Proportionality requires an examination of the specific circumstances of both the offender and the offence so that the "punishment fits the crime". As a by-product of such an individualized approach, there will be inevitable variation in sentences imposed for particular crimes. In M. (C.A.), supra, I stated, at para. 92:

> It has been repeatedly stressed that there is no such thing as a uniform sentence for a particular crime... . Sentencing is an inherently individualized process, and the search for a single appropriate sentence for a similar offender and a similar crime will frequently be a fruitless exercise of academic abstraction. As well, sentences for a particular offence should be expected to vary to some degree across various communities and regions in this country, as the "just and appropriate" mix of accepted sentencing goals will depend on the needs and current conditions of and in the particular community where the crime occurred.

83 My difficulty with the suggestion that the proportionality principle presumptively excludes certain offences from the conditional sentencing regime is that such an approach focuses inordinately on the gravity of the offence and insufficiently on the moral blameworthiness of the offender. This fundamentally misconstrues the nature of the principle. Proportionality requires that full consideration be given to both factors. As s. 718.1 provides:

> A sentence must be proportionate to the gravity of the offence and the degree of responsibility of the offender. [Emphasis added.]

84 Some appellate courts have held that once the statutory prerequisites are satisfied there ought to be a presumption in favour of a conditional sentence. In the instant appeal, Helper J.A. found at p. 112 that:

> Generally (though certainly not in all cases), it will be that, when a sentencing judge has attributed the appropriate weight to each of the relevant principles in determining that a fit sentence would be less than two years and has found that the offender would not be a danger to the community, a decision to allow the offender to serve his sentence in the community will be consistent with ss. 718 to 718.2.

85 It is possible to interpret these comments as implying that once the judge has found that the prerequisites to a conditional sentence are met, a conditional sentence would presumably be consistent with the fundamental purpose and principles of sentencing. Assuming that Helper J.A. intended to suggest that there ought to be a presumption in favour of a conditional sentence once the prerequisites are met, I respectfully disagree with her. For the same reasons that I rejected the use of presumptions against conditional sentences, I also reject presumptions in favour of them. The particular circumstances of the offender and the offence must be considered in each case.

(b) A Need for Starting Points?

86 An individualized sentencing regime will of necessity entail a certain degree of disparity in sentencing. I recognize that it is important for appellate courts to minimize, to the greatest extent possible, "the disparity of sentences imposed by sentencing judges for similar offenders and similar offences committed throughout Canada": M. (C.A.), supra, at para. 92. Towards this end, this Court held in R. v. McDonnell, [1997] 1 S.C.R. 948, that "starting point sentences" may be set out as guides to lower courts in order to achieve greater uniformity and consistency. I am also acutely aware of the need to provide guidance to lower courts regarding the use of the conditional sentence, as it is a new sanction which has created a considerable amount of controversy and confusion in its short life.

87 That said, I do not find it necessary to resort to starting points in respect of specific offences to provide guidance as to the proper use of conditional sentences. In my view, the risks posed by starting points, in the form of offence-specific presumptions in favour of incarceration, outweigh their benefits. Starting points are most useful in circumstances where there is the potential for a large disparity between sentences imposed for a particular crime because the range of sentence set out in the Code is particularly broad. In the case of conditional sentences, however, the statutory prerequisites of s. 742.1 considerably narrow the range of cases in which a conditional sentence may be imposed. A conditional sentence may only be imposed on non-dangerous offenders who would otherwise have received a jail sentence of less than two years. Accordingly, the potential disparity of sentence between those offenders who were candidates for a conditional sentence and received a jail term, and those who received a conditional sentence, is relatively small.

88 The minimal benefits of uniformity in these circumstances are exceeded by the costs of the associated loss of individualization in sentencing. By creating offence-specific starting points, there is a risk that these starting points will evolve into de facto minimum sentences of imprisonment. This would thwart Parliament's intention of not excluding particular categories of offence from the conditional sentencing regime. It could also result in the imposition of disproportionate sentences in some cases.

89 Given the narrow range of application for conditional sentences, I am of the opinion that a consideration of the principles of sentencing themselves, without offence-specific presumptions, can provide sufficient guidance as to whether a conditional sentence should be imposed. Some principles militate in favour of a conditional sentence, whereas others favour incarceration. It is the task of this Court to articulate, in general terms, which principles favour each sanction. Although it cannot ensure uniformity of result, the articulation of these principles can at least ensure uniformity in approach to the imposition of conditional sentences. It is to this task that I now turn.

(c) Principles Militating For and Against a Conditional Sentence

90 First, a consideration of ss. 718.2(d) and 718.2(e) leads me to the conclusion that serious consideration should be given to the imposition of a conditional sentence in all cases where the first three statutory prerequisites are satisfied. Sections 718.2(d) and 718.2(e) codify the important principle of restraint in sentencing and were specifically enacted, along with s. 742.1, to help reduce the rate of incarceration in Canada. Accordingly, it would be an error in principle not to consider the possibility of a conditional sentence seriously when the statutory prerequisites are met. Failure to advert to the possibility of a conditional sentence in reasons for sentence where there are reasonable grounds for finding that the first three statutory prerequisites have been met may well constitute reversible error.

91 I pause here to consider an interpretive difficulty posed by s. 718.2(e). By its terms, s. 718.2(e) requires judges to consider "all available sanctions other than imprisonment that are reasonable in the circumstances" (emphasis added). A conditional sentence, however, is defined as a sentence of imprisonment. As a sentence of imprisonment, it cannot be an alternative to imprisonment. It would therefore appear as though s. 718.2(e) has no bearing on the sentencing judge's decision as to whether a conditional sentence or a jail term should be imposed. Indeed, if interpreted in the technical sense ascribed to imprisonment in Part XXIII of the Code, s. 718.2(e) would only be relevant to the judge's preliminary determination as to whether a sentence of imprisonment, as opposed to a probationary measure, should be imposed. Once the sentencing judge rejects a probationary sentence as inappropriate, the legislative force of s. 718.2(e) is arguably spent.

92 This interpretation seems to fly in the face of Parliament's intention in enacting s. 718.2(e) -- reducing the rate of incarceration. As this Court held in Gladue, supra, at para. 40:

> The availability of the conditional sentence of imprisonment, in particular, alters the sentencing landscape in a manner which gives an entirely new meaning to the principle that imprisonment should be resorted to only where no other sentencing option is reasonable in the circumstances. The creation of the conditional sentence suggests, on its face, a desire to lessen the use of incarceration. The general principle expressed in s. 718.2(e) must be construed and applied in this light. [Emphasis added.]

Moreover, if this interpretation of s. 718.2(e) were adopted, it could lead to absurd results in relation to aboriginal offenders. The particular circumstances of aboriginal offenders would only be relevant in deciding whether to impose probationary sentences, and not in deciding whether a conditional sentence should be preferred to incarceration. This would greatly diminish the remedial purpose animating Parliament's enactment of this provision, which contemplates the greater use of conditional sentences and other alternatives to incarceration in cases of aboriginal offenders.

93 The language used in the French version avoids this difficulty. The French version reads as follows:

> 718.2 Le tribunal détermine la peine à infliger compte tenu également des principes suivants:
>
> ...

e) l'examen de toutes les sanctions substitutives applicables qui sont justifiées dans les circonstances, plus particulièrement en ce qui concerne les délinquants autochtones. [Emphasis added.]

94 The use of "sanctions substitutives" for "sanctions other than imprisonment" in the French version of this provision means that s. 718.2(e) plays a role not only in the decision as to whether imprisonment or probationary measures should be imposed (preliminary step of the analysis), but also in the decision as to whether to impose a conditional sentence of imprisonment since conditional sentences are clearly "sanctions substitutives" to incarceration.

95 The French version and the English version of s. 718.2(e) are therefore in conflict. In conformity with a long-standing principle of interpretation, to resolve the conflict between the two official versions, we have to look for the meaning common to both: see for instance Kwiatkowsky v. Minister of Employment and Immigration, [1982] 2 S.C.R. 856, at pp. 863-64; Gravel v. City of St-Léonard, [1978] 1 S.C.R. 660, at p. 669; Pfizer Co. v. Deputy Minister of National Revenue for Customs and Excise, [1977] 1 S.C.R. 456, at pp. 464-65; Tupper v. The Queen, [1967] S.C.R. 589, at p. 593; Goodyear Tire and Rubber Co. of Canada v. T. Eaton Co., [1956] S.C.R. 610, at p. 614; P.-A. Côté, Interprétation des lois (3rd ed. 1999), at pp. 412-15. Accordingly, the word "imprisonment" in s. 718.2(e) should be interpreted as "incarceration" rather than in its technical sense of encompassing both incarceration and a conditional sentence. Read in this light, s. 718.2(e) clearly exerts an influence on the sentencing judge's determination as to whether to impose a conditional sentence as opposed to a jail term.

96 Both ss. 718.2(d) and 718.2(e) seek to vindicate the important objective of restraint in the use of incarceration. However, neither seeks to do so at all costs. Section 718.2(d) provides that "an offender should not be deprived of liberty, if less restrictive sanctions may be appropriate in the circumstances" (emphasis added). Section 718.2(e) provides that "all available sanctions other than imprisonment that are reasonable in the circumstances should be considered" (emphasis added). In my view, a determination of when less restrictive sanctions are "appropriate" and alternatives to incarceration "reasonable" in the circumstances requires a consideration of the other principles of sentencing set out in ss. 718 to 718.2

97 In determining which principles favour of a conditional sentence and which favour incarceration, it is necessary to consider again the nature and purpose of the conditional sentence. Through an appreciation of Parliament's intention in enacting this new sanction and the mischief it seeks to redress, trial judges will be better able to make appropriate use of this innovative tool.

98 The conditional sentence, as I have already noted, was introduced in the amendments to Part XXIII of the Code. Two of the main objectives underlying the reform of Part XXIII were to reduce the use of incarceration as a sanction and to give greater prominence to the principles of restorative justice in sentencing -- the objectives of rehabilitation, reparation to the victim and the community, and the promotion of a sense of responsibility in the offender.

99 The conditional sentence facilitates the achievement of both of Parliament's objectives. It affords the sentencing judge the opportunity to craft a sentence with appropriate conditions that can lead to the rehabilitation of the offender, reparations to the community, and the promotion of a sense of responsibility in ways that jail cannot. However, it is also a punitive sanction. Indeed, it is the punitive aspect of a conditional sentence that distinguishes it from probation. As discussed above, it was not Parliament's intention that offenders who would otherwise have gone to jail for up to two years less a day now be given probation or some equivalent thereof.

100 Thus, a conditional sentence can achieve both punitive and restorative objectives. To the extent that both punitive and restorative objectives can be achieved in a given case, a conditional sentence is likely a better sanction than incarceration. Where the need for punishment is particularly pressing, and there is little opportunity to achieve any restorative objectives, incarceration will likely be the more attractive sanction. However, even where restorative objectives cannot be readily satisfied, a conditional sentence will be preferable to incarceration in cases where a conditional sentence can achieve the objectives of denunciation and deterrence as effectively as incarceration. This follows from the principle of restraint in s. 718.2(d) and (e), which militates in favour of alternatives to incarceration where appropriate in the circumstances.

101 I turn now to the question of when a conditional sentence may be appropriate having regard to the six sentencing objectives set out in s. 718.

(i) Denunciation

102 Denunciation is the communication of society's condemnation of the offender's conduct. In M. (C.A.), supra, at para. 81, I wrote:

> In short, a sentence with a denunciatory element represents a symbolic, collective statement that the offender's conduct should be punished for encroaching on our society's basic code of values as enshrined within our substantive criminal law. As Lord Justice Lawton stated in R. v. Sargeant (1974), 60 Cr. App. R. 74, at p. 77: "society, through the courts, must show its abhorrence of particular types of crime, and the only way in which the courts can show this is by the sentences they pass".

Incarceration will usually provide more denunciation than a conditional sentence, as a conditional sentence is generally a more lenient sentence than a jail term of equivalent duration. That said, a conditional sentence can still provide a significant amount of denunciation. This is particularly so when onerous conditions are imposed and the duration of the conditional sentence is extended beyond the duration of the jail sentence that would ordinarily have been imposed in the circumstances. I will discuss each point in turn.

103 First, the conditions should have a punitive aspect. Indeed, the need for punitive conditions is the reason why a probationary sentence was rejected and a sentence of imprisonment of less than two years imposed. As stated above, conditions such as house arrest should be the norm, not the exception. This means that the offender should be confined to his or her home except when working, attending school, or fulfilling other conditions of his or her sentence, e.g. community service, meeting with the supervisor, or participating in treatment programs. Of course, there will need to be exceptions for medical emergencies, religious observance, and the like.

104 Second, although a literal reading of s. 742.1 suggests that a conditional sentence must be of equivalent duration to the jail term that would otherwise have been imposed, I have explained earlier why such a literal interpretation of s. 742.1 should be eschewed. Instead, the preferred approach is to have the judge reject a probationary sentence and a penitentiary term as inappropriate in the circumstances, and then consider whether a conditional sentence of less than two years would be consistent with the fundamental purpose and principles of sentencing, provided the statutory prerequisites are met. This approach does not require that there be any equivalence between the duration of the conditional sentence and the jail term that would otherwise have been imposed. The sole requirement is that the duration and conditions of a conditional sentence make for a just and appropriate sentence: see Brady, supra, at para. 111; Ursel, supra, at pp. 284-86 and 291-92; Pierce, supra, at p. 39; J. V. Roberts, "The Hunt for the Paper Tiger: Conditional Sentencing after Brady" (1999), 42 Crim. L.Q. 38, at pp. 47-52.

105 The stigma of a conditional sentence with house arrest should not be underestimated. Living in the community under strict conditions where fellow residents are well aware of the offender's criminal misconduct can provide ample denunciation in many cases. In certain circumstances, the shame of encountering members of the community may make it even more difficult for the offender to serve his or her sentence in the community than in prison.

106 The amount of denunciation provided by a conditional sentence will be heavily dependent on the circumstances of the offender, the nature of the conditions imposed, and the community in which the sentence is to be served. As a general matter, the more serious the offence and the greater the need for denunciation, the longer and more onerous the conditional sentence should be. However, there may be certain circumstances in which the need for denunciation is so pressing that incarceration will be the only suitable way in which to express society's condemnation of the offender's conduct.

(ii) Deterrence

107 Incarceration, which is ordinarily a harsher sanction, may provide more deterrence than a conditional sentence. Judges should be wary, however, of placing too much weight on deterrence when choosing between a conditional sentence and incarceration: see Wismayer, supra, at p. 36. The empirical evidence suggests that the deterrent effect of incarceration is uncertain: see generally Sentencing Reform: A Canadian Approach, supra, at pp. 136-37. Moreover, a conditional sentence can provide significant deterrence if sufficiently punitive conditions are imposed and the public is made aware of the severity of these sentences. There is also the possibility of deterrence through the use of community service orders, including those in which the offender may be obliged to speak to members of the community about the evils of the particular criminal conduct in which he or she engaged, assuming the offender were amenable to such a condition. Nevertheless, there may be circumstances in which the need for deterrence will warrant incarceration. This will depend in part on whether the offence is one in which the effects of incarceration are likely to have a real deterrent effect, as well as on the circumstances of the community in which the offences were committed.

(iii) Separation

108 The objective of separation is not applicable in determining whether a conditional sentence would be consistent with the fundamental purpose and principles of sentencing because it is a prerequisite of a conditional sentence that the offender not pose a danger to the community. Accordingly, it is not necessary to completely separate the offender from society. To the extent that incarceration, which leads to the complete separation of offenders, is warranted in circumstances where the statutory prerequisites are met, it is as a result of the objectives of denunciation and deterrence, not the need for separation as such.

(iv) Restorative Objectives

109 While incarceration may provide for more denunciation and deterrence than a conditional sentence, a conditional sentence is generally better suited to achieving the restorative objectives of rehabilitation, reparations, and promotion of a sense of responsibility in the offender. As this Court held in Gladue, supra, at para. 43, "[r]estorative sentencing goals do not usually correlate with the use of prison as a sanction". The importance of these goals is not to be underestimated, as they are primarily responsible for lowering the rate of recidivism. Consequently, when the objectives of rehabilitation, reparation, and promotion of a sense of responsibility may realistically be achieved in the case of a particular offender, a conditional sentence will likely be the appropriate sanction, subject to the denunciation and deterrence considerations outlined above.

110 I will now consider examples of conditions that seek to vindicate these objectives. There are any number of conditions a judge may impose in order to rehabilitate an offender. Mandatory treatment orders may be imposed, such as psychological counseling and alcohol and drug rehabilitation. It is well known that sentencing an offender to a term of incarceration for an offence related to a drug addiction, without addressing the addiction, will probably not lead to the rehabilitation of the offender. The Final Report of the Commission of Inquiry into the Non-Medical Use of Drugs (1973) noted at p. 59 that:

> These adverse effects of imprisonment are particularly reflected in the treatment of drug offenders. Our investigations suggest that there is considerable circulation of drugs within penal institutions, that offenders are reinforced in their attachment to the drug culture, and that in many cases they are introduced to certain kinds of drug use by prison contacts. Thus imprisonment does not cut off all contact with drugs or the drug subculture, nor does it cut off contact with individual drug users. Actually, it increases exposure to the influence of chronic, harmful drug users.

111 House arrest may also have a rehabilitative effect to a certain extent in so far as it prevents the offender from engaging in habitual anti-social associations and promotes pro-social behaviors such as attendance at work or educational institutions: see Roberts, "The Hunt for the Paper Tiger: Conditional Sentencing after Brady", supra, at p. 65.

112 The objectives of reparations to the victim and the community, as well as the promotion of a sense of responsibility in offenders and acknowledgment of the harm done to victims and to the community may also be well served by a conditional sentence. For example, in some cases, restitution orders to compensate the victim may be made a condition. Furthermore, the imposition of a condition of community service can assist the offender in making reparations to the community and in promoting a sense of responsibility. An interesting possibility in this regard would be an order that the offender speak in public about the unfortunate consequences of his or her conduct, assuming the offender were amenable to such a condition. Not only could such an order promote a sense of responsibility and an acknowledgment of the harm done by the offender, it could also further the objective of deterrence, as I discussed above. In my view, the use of community service orders should be encouraged, provided that there are suitable programs available for the offender in the community. By increasing the use of community service orders, offenders will be seen by members of the public as paying back their debt to society. This will assist in contributing to public respect for the law.

(v) Summary

113 In sum, in determining whether a conditional sentence would be consistent with the fundamental purpose and principles of sentencing, sentencing judges should consider which sentencing objectives figure most prominently in the factual circumstances of the particular case before them. Where a combination of both punitive and restorative objectives may be achieved, a conditional sentence will likely be more appropriate than incarceration. In determining whether restorative objectives can be satisfied in a particular case, the judge should consider the offender's prospects of rehabilitation, including whether the offender has proposed a particular plan of rehabilitation; the availability of appropriate community service and treatment programs; whether the offender has acknowledged his or her wrongdoing and expresses remorse; as well as the victim's wishes as revealed by the victim impact statement (consideration of which is now mandatory pursuant to s. 722 of the Code). This list is not exhaustive.

114 Where punitive objectives such as denunciation and deterrence are particularly pressing, such as cases in which there are aggravating circumstances, incarceration will generally be the preferable sanction. This may be so notwithstanding the fact that restorative goals might be achieved by a conditional sentence. Conversely, a conditional sentence may provide sufficient denunciation and deterrence, even in cases in which restorative objectives are of diminished importance, depending on the nature of the conditions imposed, the duration of the conditional sentence, and the circumstances of the offender and the community in which the conditional sentence is to be served.

115 Finally, it bears pointing out that a conditional sentence may be imposed even in circumstances where there are aggravating circumstances relating to the offence or the offender. Aggravating circumstances will obviously increase the need for denunciation and deterrence. However, it would be a mistake to rule out the possibility of a conditional sentence ab initio simply because aggravating factors are present. I repeat that each case must be considered individually.

116 Sentencing judges will frequently be confronted with situations in which some objectives militate in favour of a conditional sentence, whereas others favour incarceration. In those cases, the trial judge will be called upon to weigh the various objectives in fashioning a fit sentence. As La Forest J. stated in R. v. Lyons, [1987] 2 S.C.R. 309, at p. 329, "[i]n a rational system of sentencing, the respective importance of prevention, deterrence, retribution and rehabilitation will vary according to the nature of the crime and the circumstances of the offender". There is no easy test or formula that the judge can apply in weighing these factors. Much will depend on the good judgment and wisdom of sentencing judges, whom Parliament vested with considerable discretion in making these determinations pursuant to s. 718.3.

(d) Appropriate Conditions

117 In the event that a judge chooses to impose a conditional sentence, there are five compulsory conditions listed in s. 742.3(1) that must be imposed. The judge also has considerable discretion in imposing optional conditions pursuant to s. 742.3(2). There are a number of principles that should guide the judge in exercising this discretion. First, the conditions must ensure the safety of the community. Second, conditions must be tailored to fit the particular circumstances of the offender and the offence. The type of conditions imposed will be a function of the sentencing judge's creativity. However, conditions will prove fruitless if the offender is incapable of abiding by them, and will increase the probability that the offender will be incarcerated as a result of breaching them. Third, punitive conditions such as house arrest should be the norm, not the exception. Fourth, the conditions must be realistically enforceable. This requires a consideration of the available resources in the community in which the sentence is to be served. I agree with Rosenberg J.A., who, in "Recent Developments in Sentencing", a paper prepared for the National Judicial Institute's Supreme Court of Nova Scotia Education Seminar in Halifax, February 25-26, 1999, at p. 63, wrote that:

> ... the courts must be careful not to impose conditions that are purely cosmetic and are incapable of effective enforcement. For example, I would think that any condition that can only be effectively enforced through an intolerable intrusion into the privacy of innocent persons would be problematic. Conditions that impose an unacceptable burden on the supervisor might also be of dubious value. If the conditions that the court imposes are impractical, the justice system will be brought into disrepute.

D. Burden of Proof

118 It is submitted by the intervener the Attorney General for Ontario that the offender has the burden of proving that a conditional sentence should be imposed pursuant to s. 742.1. According to the Attorney General:

> [W]hen a sentencing court determines that a reformatory sentence of imprisonment is an appropriate sentence for an offender, there is, in effect, a rebuttable presumption that this custodial sentence will prevail unless the offender can convince the sentencing Court to make the sentence of imprisonment "conditional". [Emphasis in original.]

119 The Attorney General for Ontario's position seems to be premised on a rigid two-step approach, which I rejected for the reasons explained earlier. The Attorney General submits that the offender has to establish that: (a) he or she would not endanger the safety of the community by serving a conditional sentence; and (b) the imposition of a conditional sentence would be consistent with the fundamental purpose and principles set out in ss. 718 to 718.2.

120 I disagree. The wording used in s. 742.1 does not attribute to either party the onus of establishing that the offender should or should not receive a conditional sentence. To inform his or her decision about the appropriate sentence, the judge can take into consideration all the evidence, no matter who adduces it (Ursel, supra, at pp. 264-65 and 287).

121 In matters of sentencing, while each party is expected to establish elements in support of its position as to the appropriate sentence that should be imposed, the ultimate decision as to what constitutes the best disposition is left to the discretion of the sentencing judge. This message is explicit in s. 718.3(1) and (2):

> 718.3 (1) Where an enactment prescribes different degrees or kinds of punishment in respect of an offence, the punishment to be imposed is, subject to the limitations prescribed in the enactment, in the discretion of the court that convicts a person who commits the offence.
>
> (2) Where an enactment prescribes a punishment in respect of an offence, the punishment to be imposed is, subject to the limitations prescribed in the enactment, in the discretion of the court that convicts a person who commits the offence, but no punishment is a minimum punishment unless it is declared to be a minimum punishment.

122 The sentencing judge can take into account the submissions and evidence presented by counsel (s. 723), but is in no way bound by them in the decision as to the sentence. Having said this, in practice, it will generally be the offender who is best situated to convince the judge that a conditional sentence is indeed appropriate. Therefore, it would be in the offender's best interests to establish those elements militating in favour of a conditional sentence: see Ursel, supra, at pp. 264-65; R. v. Fleet (1997), 120 C.C.C. (3d) 457 (Ont. C.A.), at para. 26. For instance, the offender should inform the judge of his or her remorse, willingness to repair and acknowledgment of responsibility, and propose a plan of rehabilitation. The offender could also convince the judge that he or she would not endanger the safety of the community if appropriate conditions were imposed. It would be to the great benefit of the offender to make submissions in this regard. I would also note the importance of the role of the supervision officer in informing the judge on these issues.

E. Deference Owed to Sentencing Judges

123 In recent years, this Court has repeatedly stated that the sentence imposed by a trial court is entitled to considerable deference from appellate courts: see Shropshire, supra, at paras. 46-50; M. (C.A.), supra, at paras. 89-94; McDonnell, supra, at paras. 15-17 (majority); R. v. W. (G.), [1999] 3 S.C.R. 597, at paras. 18-19. In M. (C.A.), at para. 90, I wrote:

> Put simply, absent an error in principle, failure to consider a relevant factor, or an overemphasis of the appropriate factors, a court of appeal should only intervene to vary a sentence imposed at trial if the sentence is demonstrably unfit. Parliament explicitly vested sentencing judges with a discretion to determine the appropriate degree and kind of punishment under the Criminal Code. [Emphasis in original.]

124 Several provisions of Part XXIII confirm that Parliament intended to confer a wide discretion upon the sentencing judge. As a general rule, ss. 718.3(1) and 718.3(2) provide that the degree and kind of punishment to be imposed is left to the discretion of the sentencing judge. Moreover, the opening words of s. 718 specify that the sentencing judge must seek to achieve the fundamental purpose of sentencing "by imposing just sanctions that have one or more of the following objectives" (emphasis added). In the context of the conditional sentence, s. 742.1 provides that the judge "may" impose a conditional sentence and enjoys a wide discretion in the drafting of the appropriate conditions, pursuant to s. 742.3(2).

125 Although an appellate court might entertain a different opinion as to what objectives should be pursued and the best way to do so, that difference will generally not constitute an error of law justifying interference. Further, minor errors in the sequence of application of s. 742.1 may not warrant intervention by appellate courts. Again, I stress that appellate courts should not second-guess sentencing judges unless the sentence imposed is demonstrably unfit.

126 As explained in M. (C.A.), supra, at para. 91:

> This deferential standard of review has profound functional justifications. As Iacobucci J. explained in Shropshire, at para. 46, where the sentencing judge has had the benefit of presiding over the trial of the offender, he or she will have had the comparative advantage of having seen and heard the witnesses to the crime. But in the absence of a full trial, where the offender has pleaded guilty to an offence and the sentencing judge has only enjoyed the benefit of oral and written sentencing submissions (as was the case in both Shropshire and this instance), the argument in favour of deference remains compelling. A sentencing judge still enjoys a position of advantage over an appellate judge in being able to directly assess the sentencing submissions of both the Crown and the offender. A sentencing judge also possesses the unique qualifications of experience and judgment from having served on the front lines of our criminal justice system. Perhaps most importantly, the sentencing judge will normally preside near or within the community which has suffered the consequences of the offender's crime. As such, the sentencing judge will have a strong sense of the particular blend of sentencing goals that will be "just and appropriate" for the protection of that community. The determination of a just and appropriate sentence is a delicate art which attempts to balance carefully the societal goals of sentencing against the moral blameworthiness of the offender and the circumstances of the offence, while at all times taking into account the needs and current conditions of and in the community. The discretion of a sentencing judge should thus not be interfered with lightly. [Emphasis added.]

This last justification is particularly relevant in the case of conditional sentences. Crafting appropriate conditions requires knowledge of both the needs and resources of the community.

VI. Summary

127 At this point, a short summary of what has been said in these reasons might be useful:

1. Bill C-41 in general and the conditional sentence in particular were enacted both to reduce reliance on incarceration as a sanction and to increase the use of principles of restorative justice in sentencing.
2. A conditional sentence should be distinguished from probationary measures. Probation is primarily a rehabilitative sentencing tool. By contrast, Parliament intended conditional sentences to include both punitive and rehabilitative aspects. Therefore, conditional sentences should generally include punitive conditions that are restrictive of the offender's liberty. Conditions such as house arrest should be the norm, not the exception.
3. No offences are excluded from the conditional sentencing regime except those with a minimum term of imprisonment, nor should there be presumptions in favour of or against a conditional sentence for specific offences.
4. The requirement in s. 742.1(a) that the judge impose a sentence of imprisonment of less than two years does not require the judge to first impose a sentence of imprisonment of a fixed duration before considering whether that sentence can be served in the community. Although this approach is suggested by the text of s. 742.1 (a), it is unrealistic and could lead to unfit sentences in some cases. Instead, a purposive interpretation of s. 742.1(a) should be adopted. In a preliminary determination, the sentencing judge should reject a penitentiary term and probationary measures as inappropriate. Having determined that the appropriate range of sentence is a term of imprisonment of less than two years, the judge should then consider whether it is appropriate for the offender to serve his or her sentence in the community.
5. As a corollary of the purposive interpretation of s. 742.1(a), a conditional sentence need not be of equivalent duration to the sentence of incarceration that would otherwise have been imposed. The sole requirement is that the duration and conditions of a conditional sentence make for a just and appropriate sentence.
6. The requirement in s. 742.1(b) that the judge be satisfied that the safety of the community would not be endangered by the offender serving his or her sentence in the community is a condition precedent to the imposition of a conditional sentence, and not the primary consideration in determining whether a conditional sentence is appropriate. In making this determination, the judge should consider the risk posed by the specific offender, not the broader risk of whether the imposition of a conditional sentence would endanger the safety of the community by providing insufficient general deterrence or undermining general respect for the law. Two factors should be taken into account: (1) the risk of the offender re-offending; and (2) the gravity of the damage that could ensue in the event of re-offence. A consideration of the risk posed by the offender should include the risk of any criminal activity, and not be limited solely to the risk of physical or psychological harm to individuals.
7. Once the prerequisites of s. 742.1 are satisfied, the judge should give serious consideration to the possibility of a conditional sentence in all cases by examining whether a conditional sentence is consistent with the fundamental purpose and principles of sentencing set out in ss. 718 to 718.2. This follows from Parliament's clear message to the judiciary to reduce the use of incarceration as a sanction.
8. A conditional sentence can provide significant denunciation and deterrence. As a general matter, the more serious the offence, the longer and more onerous the conditional sentence should be. There may be some circumstances, however, where the need for denunciation or deterrence is so pressing that incarceration will be the only suitable way in which to express society's condemnation of the offender's conduct or to deter similar conduct in the future.

9. Generally, a conditional sentence will be better than incarceration at achieving the restorative objectives of rehabilitation, reparations to the victim and the community, and promotion of a sense of responsibility in the offender and acknowledgment of the harm done to the victim and the community.
10. Where a combination of both punitive and restorative objectives may be achieved, a conditional sentence will likely be more appropriate than incarceration. Where objectives such as denunciation and deterrence are particularly pressing, incarceration will generally be the preferable sanction. This may be so notwithstanding the fact that restorative goals might be achieved. However, a conditional sentence may provide sufficient denunciation and deterrence, even in cases in which restorative objectives are of lesser importance, depending on the nature of the conditions imposed, the duration of the sentence, and the circumstances of both the offender and the community in which the conditional sentence is to be served.
11. A conditional sentence may be imposed even where there are aggravating circumstances, although the need for denunciation and deterrence will increase in these circumstances.
12. No party is under a burden of proof to establish that a conditional sentence is either appropriate or inappropriate in the circumstances. The judge should consider all relevant evidence, no matter by whom it is adduced. However, it would be in the offender's best interests to establish elements militating in favour of a conditional sentence.
13. Sentencing judges have a wide discretion in the choice of the appropriate sentence. They are entitled to considerable deference from appellate courts. As explained in M. (C.A.), supra, at para. 90: "Put simply, absent an error in principle, failure to consider a relevant factor, or an overemphasis of the appropriate factors, a court of appeal should only intervene to vary a sentence imposed at trial if the sentence is demonstrably unfit".

VII. Application to the Case at Hand

128 In the case at hand, Keyser J. considered that a term of imprisonment of 18 months was appropriate and declined to permit the respondent to serve his term in the community. She found that, while the respondent would not endanger the safety of the community by serving a conditional sentence, such a sentence would not be in conformity with the objectives of s. 718. In her view, even if incarceration was not necessary to deter the respondent from similar future conduct or necessary for his rehabilitation, incarceration was necessary to denounce the conduct of the respondent and to deter others from engaging in similar conduct.

129 While Keyser J. seems to have proceeded according to a rigid two-step process, in deviation from the approach I have set out, I am not convinced that an 18-month sentence of incarceration was demonstrably unfit for these offences and this offender. I point out that the offences here were very serious, and that they had resulted in a death and in severe bodily harm. Moreover, dangerous driving and impaired driving may be offences for which harsh sentences plausibly provide general deterrence. These crimes are often committed by otherwise law-abiding persons, with good employment records and families. Arguably, such persons are the ones most likely to be deterred by the threat of severe penalties: see R. v. McVeigh (1985), 22 C.C.C. (3d) 145 (Ont. C.A.), at p. 150; R. v. Biancofiore (1997), 119 C.C.C. (3d) 344 (Ont. C.A.), at paras. 18-24; R. v. Blakeley (1998), 40 O.R. (3d) 541 (C.A.), at pp. 542-43.

130 I hasten to add that these comments should not be taken as a directive that conditional sentences can never be imposed for offences such as dangerous driving or impaired driving. In fact, were I a trial judge, I might have found that a conditional sentence would have been appropriate in this case. The respondent is still very young, he had no prior record and no convictions since the accident, he seems completely rehabilitated, he wants to go back to school, he has already suffered a lot by causing the death of a friend and was himself in a coma for some time. To make sure that the objectives of denunciation and general deterrence would have been sufficiently addressed, I might have imposed conditions such as house arrest and a community service order requiring the offender to speak to designated groups about the consequences of dangerous driving, as was the case in Parker, supra, at p. 239, and R. v. Hollinsky (1995), 103 C.C.C. (3d) 472 (Ont. C.A.).

131 However, trial judges are closer to their community and know better what would be acceptable to their community. Absent evidence that the sentence imposed by the trial judge was demonstrably unfit, the Court of Appeal should not have interfered to substitute its own opinion for that of the sentencing judge. The trial judge did not commit a reversible error in principle and she appropriately considered all the relevant factors. Although the Court of Appeal's decision is entitled to some deference (see the companion appeal R. v. R.A.R., [2000] 1 S.C.R. 163, 2000 SCC 8, at paras. 20-21), in my opinion it erred in holding that the sentencing judge had given undue weight to the objective of denunciation. I see no ground for the Court of Appeal's intervention.

VIII. Disposition

132 I would allow the appeal. Accordingly, the 18-month sentence of incarceration imposed by the trial judge should be restored. However, given that the respondent has already served the conditional sentence imposed by the Court of Appeal in its entirety, and that the Crown stated in oral argument that it was not seeking any further punishment, I would stay the service of the sentence of incarceration.

cp/d/qlhbb

13

Case Name:
Winters v. Legal Services Society

Arthur Robert Winters, appellant;
v.
Legal Services Society and the Attorney General of British Columbia, respondents.

[1999] S.C.J. No. 49

[1999] A.C.S. no 49

[1999] 3 S.C.R. 160

[1999] 3 R.C.S. 160

177 D.L.R. (4th) 94

244 N.R. 203

[1999] 9 W.W.R. 327

J.E. 99-1828

128 B.C.A.C. 161

73 B.C.L.R. (3d) 193

137 C.C.C. (3d) 371

27 C.R. (5th) 1

66 C.R.R. (2d) 241

90 A.C.W.S. (3d) 844

43 W.C.B. (2d) 326

File No.: 26180.

Supreme Court of Canada

1998: December 3 / 1999: September 15.

Present: Lamer C.J. and L'Heureux-Dubé, Gonthier, Cory, McLachlin, Iacobucci, Major, Bastarache and Binnie JJ.

ON APPEAL FROM THE COURT OF APPEAL FOR BRITISH COLUMBIA (81 paras.)

Prisons -- Disciplinary hearings -- Legal services -- Solitary confinement imposed on inmate following alleged assault -- Legal Services Society denying inmate legal services for disciplinary hearing -- Whether inmate entitled to legal services under s. 3(2) of the Legal Services Society Act -- If so, level of services to which he is entitled -- Legal Services Society Act, R.S.B.C. 1979, c. 227, s. 3(2)(b).

While serving a life sentence in a federal penitentiary, the appellant was charged with assaulting another person under the Corrections and Conditional Release Act. As a result of the serious disciplinary charge, the appellant faced the possibility of punishment by way of solitary confinement. Prior to being charged with the offence, he was placed in solitary confinement. He remained there for 38 days. The disciplinary hearing was repeatedly adjourned to await the decision on the appellant's eligibility for counsel. His request that counsel be provided by the respondent Legal Services Society was refused, and his appeal to the Society's head office was dismissed. The appellant brought a petition before the British Columbia Supreme Court for a declaration that the Society is required to provide him with counsel. The petition was dismissed and the Court of Appeal upheld that decision.

Held (Cory J. dissenting in part): The appeal should be allowed.

Per Lamer C.J. and L'Heureux-Dubé, Gonthier, McLachlin, Iacobucci, Major, Bastarache and Binnie JJ.: There was agreement with Cory J. that the appellant has established a statutory right to "legal services" in connection with his prison disciplinary hearing. However, the Legal Services Society retains a discretion to determine the level of legal services to which the appellant is entitled. In making its decision, the Society must consider all of the relevant circumstances of the application, including the nature of the charge, the procedure for its determination, the severity of the punishment of the applicant if convicted, and other potential indirect consequences such as loss of remission, or prejudice to a potential transfer to a lesser institution. As the Society incorrectly found that the appellant was not entitled to legal services, and as the Court does not have sufficient particulars of the offence to determine the appropriate level of legal services required by the appellant, the matter should be sent back for reconsideration.

In the case of mandatory services, the level of service is to be determined by the exigencies of the situation confronting the applicant, including the cost effectiveness of varying levels of service. The Society aims to provide legal services at least equivalent to that which a reasonable person of average means would expect to receive from a properly instructed competent member of the legal profession. These services would not necessarily amount to legal representation at the hearing even in cases where solitary confinement is an available method of discipline. In these circumstances, services ordinarily provided by a lawyer would include a preliminary investigation of the facts giving rise to the disciplinary charges, and advice about the range of potential outcomes, and the chances of success. This function could be performed by the Legal Services Society staff counsel or by a non-lawyer staff person well versed in prison matters and under the supervision of a lawyer. Although the appellant had served 38 days in solitary confinement, the issue is not moot because he still faces the prospect that a conviction will affect the application he intends to make for parole.

Per Cory J. (dissenting in part): To be eligible for counsel under s. 3(2) of the Legal Services Society Act, an applicant for legal aid assistance must meet a two-part test. First, the proceedings must be either criminal or civil in nature. If criminal, the proceedings must possibly lead to imprisonment and, if civil, to imprisonment or confinement. Prison disciplinary hearings are not criminal proceedings; their purpose is to maintain internal institutional discipline. They are civil proceedings within the meaning of s. 3(2)(b) of the Act and solitary segregation amounts to confinement within the meaning of that section.

This is because incarcerated persons possess the residual liberty interest enjoyed by the general penitentiary population and solitary confinement constitutes an additional and a severe restriction on that interest. As the appellant faced a prison disciplinary hearing which could result in the imposition of a term in solitary confinement, he is a "qualifying individual" within s. 3(2)(b) of the Act and is entitled to the requisite legal services for his disciplinary hearing.

In the circumstances of this case, the requisite legal services extend to the provision of legal counsel because the possible effects and consequences of solitary confinement require a fair hearing. Counsel is particularly important when solitary confinement is imposed as punishment because it can have a significant impact on the manner in which a prisoner is incarcerated, and may affect his right to earn remission. In addition, the Society provides counsel for post-suspension, post-revocation and detention hearings. There is no principled way to distinguish between those matters and prison disciplinary hearings.

Cases Cited

By Binnie J.

Distinguished: R. v. Rowbotham (1988), 41 C.C.C. (3d) 1; referred to: Gonzalez-Davi v. British Columbia (Legal Services Society) (1991), 55 B.C.L.R. (2d) 236; Re Mountain and Legal Services Society (1984), 5 D.L.R. (4th) 170; Landry v. Legal Services Society (1986), 3 B.C.L.R. (2d) 98; Martineau v. Matsqui Institution Disciplinary Board, [1980] 1 S.C.R. 602.

By Cory J. (dissenting in part)

Landry v. Legal Services Society (1986), 3 B.C.L.R. (2d) 98; Gonzalez-Davi v. British Columbia (Legal Services Society) (1991), 55 B.C.L.R. (2d) 236; Rizzo & Rizzo Shoes Ltd. (Re), [1998] 1 S.C.R. 27; R. v. Shubley, [1990] 1 S.C.R. 3; R. v. Wigglesworth, [1987] 2 S.C.R. 541, aff'g (1984), 7 D.L.R. (4th) 361; Martineau v. Matsqui Institution Disciplinary Board, [1980] 1 S.C.R. 602; R. v. Miller, [1985] 2 S.C.R. 613; Cardinal v. Director of Kent Institution, [1985] 2 S.C.R. 643; Morin v. National Special Handling Unit Review Committee, [1985] 2 S.C.R. 662; McCann v. The Queen, [1976] 1 F.C. 570, 29 C.C.C. (2d) 337; Howard v. Stony Mountain Institution, [1984] 2 F.C. 642; Palachik v. Kiss, [1983] 1 S.C.R. 623; Roberge v. Bolduc, [1991] 1 S.C.R. 374; Friends of the Oldman River Society v. Canada (Minister of Transport), [1992] 1 S.C.R. 3.

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Interpretation Act, R.S.B.C. 1996, c. 238, s. 8.
Legal Services Society Act, R.S.B.C. 1979, c. 227, ss. 3, 9, 10 [am. 1987, c. 25, s. 106].

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APPEAL from a judgment of the British Columbia Court of Appeal (1997), 92 B.C.A.C. 252, 39 B.C.L.R. (3d) 348, [1997] B.C.J. No. 1280 (QL), affirming a decision of the British Columbia Supreme Court, [1995] B.C.J. No. 1001 (QL), dismissing an application for a declaration that the Legal Services Society was required to provide the appellant with legal representation. Appeal allowed, Cory J. dissenting in part.

John W. Conroy, Q.C., and Michael Jackson, for the appellant.
Douglas MacAdams and Mark Benton, for the respondent the Legal Services Society.
Harvey Groberman and Neena Sharma, for the respondent the Attorney General of British Columbia.

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

The judgment of Lamer C.J. and L'Heureux-Dubé, Gonthier, McLachlin, Iacobucci, Major, Bastarache and Binnie JJ. was delivered by

1 **BINNIE J.**:-- I have had the advantage of reading the reasons of my colleague Justice Cory and agree with much of what he has written. Although it was argued that the Legal Services Society Act is a complete code under which any proceedings not correctly characterized as criminal are necessarily civil, the issue can be resolved on the more narrow ground proposed by Cory J. at para. 62, with which I agree. We come apart at the final stage of his analysis. He concludes that the appellant has a statutory right to representation by counsel at the prison disciplinary hearing (paras. 76 to 78). In my view, the appellant has established a statutory right to "legal services" in connection with his prison disciplinary hearing, but the Legal Services Society retains a discretion to determine the level of "legal services" to which the appellant is entitled in the circumstances, and the order of this Court should so provide.

2 In his original petition, repeated in his Notice of Appeal to the British Columbia Court of Appeal dated May 26, 1995, the appellant sought an order in two parts, namely

> An Order declaring that the Respondent is required by the provisions of Section 3 of the Legal Services Society Act, R.S.B.C. 1979, c. 227,
>
> (i) to provide the appellant with legal representation at a hearing on a charge of a disciplinary offence pursuant to the Corrections and Conditional Release Act, S.C. 1992, c. 20 and regulations thereunder; and
> (ii) requiring the respondent Legal Services Society of British Columbia to make legal services available to the appellant for his defence on a charge pursuant to Section 40(h) of the Corrections and Conditional Release Act of namely: fights with, assaults or threatens to assault another person, classified as a serious disciplinary offence, on the grounds that the appellant is a qualifying individual who may be imprisoned or confined through civil proceedings or in the alternative that he is a qualifying individual who is a defendant in criminal proceedings that could lead to his imprisonment. [Emphasis added.]

3 My colleague would make an order granting both branches of the relief sought. With respect, I think the relief should be limited to the second branch, namely the provision of such legal services as the

respondent Legal Services Society determines to be appropriate in the circumstances. The Society did not address this issue in the first instance, having erroneously concluded that the appellant was not entitled to mandatory legal services at all.

4 Even if it were appropriate for the Court to impose its view of the proper level of legal services, we do not have the information to make a knowledgeable decision.

5 We know the charge, the nature of the hearing and the potential consequences of conviction to the appellant but beyond that we know nothing of the facts of the alleged offence and little about the issues, legal or factual, that will arise at the hearing. At the end of the day, it may be that counsel is required at the hearing, but the Court has neither the mandate nor the information to make that decision.

6 It is important to state at the outset that the appellant does not rest his entitlement to publicly funded counsel on any constitutional ground, unlike R. v. Rowbotham (1988), 41 C.C.C. (3d) 1 (Ont. C.A.). His entitlement, if any, lies in the "mandatory services" provision of the provincial Legal Services Society Act, R.S.B.C. 1979, c. 227. He can claim no more than the statute promises to deliver. The only issue here is to what extent a prisoner who does not assert a constitutional right to publicly funded counsel can nevertheless require the Legal Services Society to provide such counsel by reason of s. 3(2) of its governing statute.

7 It is also important to note that the appellant's right to have counsel at the disciplinary hearing is not contested. It is assured by s. 31(2) of the regulations made under the federal Corrections and Conditional Release Act, S.C. 1992, c. 20. The issue is whether the provincial legal aid plan has to provide such counsel at public expense.

Background

8 The Legal Services Society, in common with legal aid plans across the country, has faced serious problems in meeting the rising demand for legal services in a period of severe government restraint. The Society is a statutory body separate from the provincial government but wholly funded by it through its annual grants. In the relevant year (1993-94) the initial grant amounted to $84.6 million. The Society overran its budget by $14.7 million, but was bailed out by a supplementary grant. In a document it circulated to "stakeholders" in the provincial legal aid field on January 10, 1994, less than a week after its letter of refusal in this case, the Society estimated that its caseload was increasing by approximately 5 percent per year. It advised stakeholders that, in order to balance its budget over the course of the next six years, its "eligible client base" (i.e. persons eligible for legal aid) would have to be cut by 43 percent on an accrued basis, assuming a constant funding of $90 million per year. Alternatively, the tariff paid to participating lawyers would have to be cut by 48 percent. In the further alternative, the shortfall could be over by some blend of reduced tariff and reduced client eligibility.

9 The Legal Services Society points out that any judicial extension of legal services classified as mandatory under the Act can have severe budgetary consequences. It estimates, for example, that the decision of the British Columbia Court of Appeal in Gonzalez-Davi v. British Columbia (Legal Services Society) (1991), 55 B.C.L.R. (2d) 236, mandating the Society to provide legal representation at immigration hearings, costs the Society about $3.5 million per year. The British Columbia legislature, it should be added, has not thought it fit to amend the statute in light of that decision.

10 Nevertheless, when considering the appropriate level of legal services to be provided in any given case, the statutory mandate of the Society does not permit it to reduce services to stay within budget. Existence of these financial constraints cannot affect the Legal Services Society's obligation under the statute, if there is one, to provide "mandatory" legal services: Re Mountain and Legal Services Society (1984), 5 D.L.R. (4th) 170 (B.C.C.A.). It explains, however, why the legislature may have wished the

Society to preserve some flexibility in the level of legal services provided.

The Statutory Entitlement

11 I accept my colleague's conclusion that the prison disciplinary proceedings in this case fall within s. 3(2) of the Legal Services Society Act. The decisions of the British Columbia Court of Appeal that have carved out and subsequently confirmed an exception to eligibility for "internal proceedings designed to foster order" should not be followed. Prison disciplinary proceedings can result in up to 30 days solitary confinement (up to 45 days in the case of multiple convictions) and, for the reasons given by my colleague, this brings the appellant within the entitlement to mandatory legal services provided under s. 3(2) of the Legal Services Society Act.

12 The Act, however, does not define the content of the "legal services" the Society has a duty to make available under s. 3(2). It merely provides that:

> 3. ...
>
> (2) The society shall ensure, for the purposes of subsection (1)(a), that legal services are available... [Emphasis added.]

with the text of subs. (1)(a) being:

> 3. (1) The objects of the society are to ensure that
>
> (a) services ordinarily provided by a lawyer are afforded to individuals who would not otherwise receive them because of financial or other reasons; and... . [Emphasis added.]

13 Section 3 uses the expression "legal services" and s. 9 shows that the term "legal services" is used in a very broad sense to include services rendered not only by lawyers or articling students but by individuals who are not lawyers at all, provided they are supervised by a lawyer. The term "legal services" is not synonymous with "legal representation" and the Act nowhere specifies a right to publicly funded legal counsel at a trial or hearing.

14 Reading the Act as a whole, it seems to me that the legislature intended the Society to have a discretion to determine when mandatory legal services under s. 3(2) ought to rise to the level of legal representation. The Court should also accept that the Society has some expertise, to which a measure of deference should be paid, in determining the exigencies of legal services in a particular case.

The Society's Decision

15 In making its decision, of course, the Society must consider all of the relevant circumstances of the application, including the nature of the charge, the procedure for its determination, the severity of the punishment of the applicant if convicted, and other potential indirect consequences such as loss of remission, or prejudice to a potential transfer to a lesser institution.

16 In this case the Legal Services Society itself did not in the first instance declare the appellant ineligible under s. 3(2) of the Act. The initial letter of referral of legal aid dated January 6, 1994, simply stated:

> Further to our telephone conversation of January 6, 1994, unfortunately I must refuse

> your application for legal aid to appoint counsel to represent you at your disciplinary hearing, set for the 26th of January, 1994 at Matsqui Institution. Your application has been refused because this is not the type of matter for which the Legal Services Society will pay a lawyer on tariff to represent you. [Emphasis added.]

17 The appeal decision of the head office of the Legal Services Society in Vancouver, however, was framed in terms of a broad exclusion from legal services based either on what has been found to be a misinterpretation of the law in Landry v. Legal Services Society (1986), 3 B.C.L.R. (2d) 98 (C.A.), or a policy based on financial constraints that "fettered" any consideration of individual circumstances. The relevant portion of the decision is contained in one sentence:

> Because of our limited resources, legal aid is not granted to persons facing disciplinary hearings.

The matter must therefore go back to the Legal Services Society for reconsideration. The remaining issue is whether, as my colleague suggests, the reconsideration must result in the provision of legal counsel at the disciplinary hearing. In my opinion it does not.

The Society's Discretion

18 The expression "services ordinarily provided by a lawyer" in s. 3(1)(a) is broad enough to include everything from preliminary advice to counsel work at a hearing. Section 10 provides that the Society has the authority to determine the priorities and criteria for the services "it or a funded agency provides" under the Act. In the case of mandatory services, the level of service is essentially determined by the exigencies of the situation confronting the applicant, not the size of the Society's bank account. If the province considers the plan is too expensive, it will have to amend the legislation to cut back on the provision of mandatory services. Nevertheless, the Society, correctly in my view, recognizes that part of the ordinary services provided by a lawyer to a client is an assessment of the cost effectiveness of varying levels of service. Few clients of ordinary means are prepared to throw away private money on legal fees without regard to the merits or other circumstances of a case. It should be equally undesirable to throw away public money.

19 The Society has recognized this reality of lawyer-client relationships in its working definition of the appropriate level of legal services. It aims to provide legal services "at least equivalent to that which a reasonable person of average means would expect to receive from a properly instructed competent member of the legal profession" (White Paper: Core Services of the Legal Services Society of British Columbia (1994)). This would not necessarily amount to legal representation at the hearing, although it might very well do so. When legal representation at the hearing is that which a reasonable person of average means expects to receive, the Society is under a statutory duty to provide counsel at the hearing, despite its understandable concern about budgetary limitations.

20 The Legal Services Society has in fact established with its discretionary funding a Prisoners' Legal Services staff counsel office at Abbottsford, British Columbia, in an area where a number of federal penal institutions have been established. Staff counsel specialize in prisoners' issues and could readily perform an evaluation function to determine the appropriate level of legal services in the circumstances.

Risk of Solitary Confinement

21 The legislature itself established risk of imprisonment as a trigger for mandatory legal services. Imprisonment includes, as my colleague demonstrates, solitary confinement as "a prison within a prison": Martineau v. Matsqui Institution Disciplinary Board, [1980] 1 S.C.R. 602, at p. 622.

22 I agree with my colleague that ordinarily the prospect of solitary confinement would persuade a reasonable person of average means to have counsel at the hearing. However, the task of the Legal Services Society is complicated by the fact that solitary confinement is theoretically available for a vast range of offences under the federal Corrections and Conditional Release Act. It may or may not be even a remote possibility in a particular case.

23 Section 40 of the Corrections and Conditional Release Act creates a list of possible charges, which runs the gamut from being "disrespectful or abusive toward a staff member in a manner that could undermine a staff member's authority" to refusing to work "without reasonable excuse", gambling, to attempted escape or participating in a disturbance. The Act does not differentiate between minor "types" of offences and serious "types" of offences.

24 The risk of solitary confinement, where it exists, flows from an administrative procedure by prison staff to allocate charges between two possible modes of trial -- "minor" charges to be tried before prison staff personnel, and "serious" charges which are tried before a disciplinary court consisting of two staff members and an independent chairperson, who must be a qualified lawyer.

25 There are no guidelines or criteria spelled out in the act or regulations governing this allocation of cases to one mode of trial or the other, but it is accepted that "serious offences" are generally those which could be said to compromise the institution's security or the personal safety of its inhabitants.

26 Only the disciplinary court chaired by an independent chairperson can impose solitary confinement, but it can do so, theoretically, in every case that comes before it. There are approximately 1,000 hearings each year before disciplinary courts in British Columbia in federal institutions alone. There are no statistics to show the percentage of these cases that resulted in solitary confinement. We were provided with no reliable statistics on either issue with respect to the risk of solitary confinement in provincial institutions.

27 While the disciplinary court has the power to impose solitary confinement in all matters referred to it, it may also, depending on its view of the gravity of the offence, impose such lesser penalties as the loss of privileges, performance of extra duties or restitution of stolen property. Solitary confinement could last between a part of a day to a maximum of 30 days for a single offence.

28 Regulation 34 of the Corrections and Conditional Release Regulations, SOR/92-620, provides that the disciplinary court must impose the least restrictive sanction commensurate with the gravity of the offence.

29 Having regard to this rather elastic disciplinary structure, I do not think the intention can be attributed to the legislature of British Columbia to mandate legal representation for everything which the federal Parliament chooses to designate as an offence carrying the potential of solitary confinement.

Application to the Facts of This Case

30 The appellant is charged with assaulting a fellow prisoner. A prison staff person ticked a box labelled "serious". We have no other particulars about the nature or gravity of the assault. In these circumstances, "services ordinarily provided by a lawyer" would include a preliminary investigation of the facts giving rise to the disciplinary charges, and advice about the range of potential outcomes, and the chances of success. This is a function that could be performed by the Legal Services Society staff counsel, or even a non-lawyer staff person who is well versed in prison matters, provided that any advice given by that person is "under the supervision of a lawyer" (s. 9). It might be expected that in many cases the best advice would be to have a lawyer at the hearing. The prospect of solitary confinement, if a plausible risk in the circumstances, would argue for such an outcome.

31 In some circumstances, however, the best advice might be that there is no useful role for a lawyer. The facts may not be in dispute. It may be apparent that solitary confinement, while theoretically available, is not a realistic possibility and that legal counsel at the hearing is unnecessary. The Society should not be required to provide more than a reasonable person of average means would provide for himself or herself.

32 A rule that required the Society to provide counsel at any hearing where the prisoner was potentially at risk of solitary confinement would impose a wholly unjustified financial burden on the Society.

Disposition

33 The Legal Services Society clearly erred in law in deciding that it was not obliged, in the circumstances, to provide "legal services" to the appellant. While the appellant has in fact served 38 days in solitary confinement for the offence, the issue is not moot because he still faces the prospect that a conviction will affect the application he intends to make for parole after 15 years under the "faint hope" provision of the Criminal Code, R.S.C., 1985, c. C-46. It is for the Legal Services Society to decide, within the proper limits of its administrative discretion, the appropriate level of "legal services" mandated by s. 3(2) of the Act in the circumstances. I would accordingly allow the appeal with costs throughout on a party and party basis, set aside the judgment of the Court of Appeal, and refer the matter to the Legal Services Society for disposition in accordance with these reasons.

The following are the reasons delivered by

34 CORY J. (dissenting in part):-- Solitary confinement may have severe consequences. Pursuant to the Corrections and Conditional Release Act, S.C. 1992, c. 20, an inmate charged with a serious disciplinary offence could face up to 30 days in solitary confinement if the offence is established. Should such an inmate be entitled, pursuant to the Legal Services Society Act, R.S.B.C. 1979, c. 227, to the provision of legal services at his hearing? That is the question raised in this appeal.

I. Factual Background

35 The appellant is serving a life sentence for aiding and abetting the commission of a first degree murder. On November 25, 1993, he was charged with assaulting another person contrary to the provisions of the Corrections and Conditional Release Act. This offence is very properly classified as serious. As a result, it was to be heard by an independent chairperson at a disciplinary hearing.

36 The appellant was charged with the offence and placed in solitary confinement in Matsqui Institution, a medium security penitentiary, until December 8, 1993. He was then transferred to Kent Institution, a maximum security facility, where he remained in solitary confinement until December 30, 1993, a total of 38 days.

37 A hearing scheduled for December 1, 1993, was adjourned when the appellant requested that he be represented by counsel. At that time, he had only a Grade 10 education. He possessed none of the skills required to conduct a trial. He had very little knowledge of the law, and was facing the prospect of spending a substantial amount of time in solitary confinement. He was also concerned that a conviction for this offence could be used as evidence against him at his parole eligibility hearing under s. 745.6 of the Criminal Code, R.S.C., 1985, c. C-46. That hearing might result in the appellant being eligible for parole after 15 years rather than 25.

38 The appellant could not afford to hire a lawyer and his attempts to retain a lawyer pro bono were unsuccessful. The disciplinary hearing reconvened on December 8, 1993, but the appellant was granted a further adjournment to January 5, 1994, to contact an employee of Prisoners' Legal Services, a branch office of the respondent Legal Services Society. Subsequently, the hearing was adjourned again to January 26, 1994.

39 On January 6, 1994, a Legal Services Society lawyer advised the appellant that, although he was financially eligible to have counsel appointed to act on his behalf, prison disciplinary hearing charges were not covered by the Legal Services Society Act. He was also told that, had he been charged under the Criminal Code, it was likely that counsel would have been appointed to act for him. The appellant appealed the decision to the Legal Services Society's head office and the hearing of the charge was adjourned to March 9, 1994, to await the outcome of the appeal. His appeal was dismissed by the Legal Services Society.

40 The appellant brought a petition before the Supreme Court of British Columbia for a declaration that the Legal Services Society is required to provide him with counsel. The petition was dismissed. The court considered itself bound by the decision in Landry v. Legal Services Society (1986), 3 B.C.L.R. (2d) 98 (C.A.). The Court of Appeal dismissed the appellant's appeal, holding that it was also bound by Landry.

II. Relevant Statutory Provisions

41 Legal Services Society Act, R.S.B.C. 1979, c. 227

3. (1) The objects of the society are to ensure that

(a) services ordinarily provided by a lawyer are afforded to individuals who would not otherwise receive them because of financial or other reasons; and
(b) education, advice and information about law are provided for the people of British Columbia.

(2) The society shall ensure, for the purposes of subsection (1)(a), that legal services are available for a qualifying individual who

(a) is a defendant in criminal proceedings that could lead to his imprisonment;
(b) may be imprisoned or confined through civil proceedings;
(c) is or may be a party to a proceeding respecting a domestic dispute that affects his physical or mental safety or health or that of his children; or
(d) has a legal problem that threatens

(i) his family's physical or mental safety or health;
(ii) his ability to feed, clothe and provide shelter for himself and his dependants; or
(iii) his livelihood.

Corrections and Conditional Release Act, S.C. 1992, c. 20

38. The purpose of the disciplinary system established by sections 40 to 44 and the regulations is to encourage inmates to conduct themselves in a manner that promotes the good order of the penitentiary, through a process that contributes to the inmates' rehabilitation and successful reintegration into the community.

...

40. An inmate commits a disciplinary offence who

(a) disobeys a justifiable order of a staff member;
(b) is, without authorization, in an area prohibited to inmates;
(c) wilfully or recklessly damages or destroys property that is not the inmate's;
(d) commits theft;
(e) is in possession of stolen property;
(f) is disrespectful or abusive toward a staff member in a manner that could undermine a staff member's authority;
(g) is disrespectful or abusive toward any person in a manner that is likely to provoke a person to be violent;
(h) fights with, assaults or threatens to assault another person;
(i) is in possession of, or deals in, contraband;
(j) without prior authorization, is in possession of, or deals in, an item that is not authorized by a Commissioner's Directive or by a written order of the institutional head;
(k) takes an intoxicant into the inmate's body;
(l) fails or refuses to provide a urine sample when demanded pursuant to section 54 or 55;
(m) creates or participates in

(i) a disturbance, or
(ii) any other activity

that is likely to jeopardize the security of the penitentiary;

(n) does anything for the purpose of escaping or assisting another inmate to escape;
(o) offers, gives or accepts a bribe or reward;
(p) without reasonable excuse, refuses to work or leaves work;
(q) engages in gambling;
(r) wilfully disobeys a written rule governing the conduct of inmates; or
(s) attempts to do, or assists another person to do, anything referred to in paragraphs (a) to (r).

...

44. (1) An inmate who is found guilty of a disciplinary offence is liable, in accordance with the regulations made under paragraphs 96(i) and (j), to one or more of the following:

(a) a warning or reprimand;
(b) a loss of privileges;
(c) an order to make restitution;

(d) a fine;
(e) performance of extra duties; and
(f) in the case of a serious disciplinary offence, segregation from other inmates for a maximum of thirty days.

III. Prior Judgments

A. British Columbia Supreme Court, [1995] B.C.J. No. 1001 (QL)

42 Fraser J. noted that the British Columbia Court of Appeal in Landry, supra, had held that prison disciplinary proceedings do not fall within s. 3(2) of the Legal Services Society Act and that there was no obligation on the Legal Services Society to provide counsel for those proceedings. However, in Gonzalez-Davi v. British Columbia (Legal Services Society) (1991), 55 B.C.L.R. (2d) 236, the Court of Appeal held that someone "threatened with confinement or imprisonment and otherwise qualified" is entitled to assistance (p. 240). Hutcheon J.A. held that Landry was distinguishable because prison disciplinary proceedings are "domestic matters involving internal administration of the institution" and Landry "should be applied only to facts of a similar nature". By way of comparison, Gonzalez-Davi was subject to arrest and detention as a result of his hearing before the Immigration Board. It was held that in these circumstances he was entitled to have counsel provided to him.

43 Fraser J. held that the petitioner was threatened with confinement or imprisonment within the meaning of Gonzalez-Davi, supra. First, he might be prejudiced at the hearing held pursuant to s. 745.6 of the Criminal Code and, second, a finding of guilt could lead to the imposition of solitary confinement for up to 30 days. It did not matter that the appellant was already in prison: parole is different from custody and ordinary custody is different from solitary confinement. However, Fraser J. also noted that the Court of Appeal in Landry implicitly held that the Legal Services Society's obligation to provide counsel is not triggered solely by the potential consequences to the applicant but is also affected by the source of the consequences and the reason for their imposition.

44 Fraser J. determined that he was bound by Landry since the Court of Appeal itself had distinguished that case in Gonzalez-Davi. He therefore dismissed the petition.

B. British Columbia Court of Appeal (1997), 39 B.C.L.R. 348

1. Esson J.A. (Newbury J.A. concurring)

45 Esson J.A. held that the question was entirely one of interpreting the Legal Services Society Act which had not been amended in any relevant particular since 1979. Landry, supra, was a considered decision and notwithstanding Gonzalez-Davi, supra, he found that this division of the Court of Appeal was bound by it.

2. McEachern C.J.B.C. (Newbury J.A. concurring)

46 McEachern C.J.B.C. noted that the appellant had requested that five judges of the Court of Appeal be assembled to hear the case but that he had declined to make such an order. He held at p. 350 that,

> ... I think the law is settled and that it would serve no purpose in my view to order that the matter be argued again. The law has stood as it is since Landry, and I do not think we should lightly reconsider these matters or order five judges to hear an appeal merely because it cannot succeed without reconsidering what appears to be satisfactorily settled law.

IV. Analysis

A. General Principles of Statutory Interpretation

47 At the core of this appeal is the correct interpretation to be given to s. 3(2) of the Legal Services Society Act. The general principles of statutory interpretation were considered most recently in Rizzo & Rizzo Shoes Ltd. (Re), [1998] 1 S.C.R. 27. Iacobucci J. set out the principles which should be applied when interpreting legislation in this manner:

1. The words of a statute "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" (E. A. Driedger, Construction of Statutes (2nd ed. 1983), at p. 87).
2. The legislature should be assumed not to have intended to produce absurd results:

> [A]n interpretation can be considered absurd if it leads to ridiculous or frivolous consequences, if it is extremely unreasonable or inequitable, if it is illogical or incoherent, or if it is incompatible with other provisions or with the object of the legislative enactment... . [Moreover,] a label of absurdity can be attached to interpretations which defeat the purpose of a statute or render some aspect of it pointless or futile. [Rizzo Shoes, supra, at para. 27, citing Driedger on the Construction of Statutes (3rd ed. 1994), at p. 88.]

3. Statutes should be deemed to be remedial. According to the Interpretation Act, R.S.B.C. 1996, c. 238, s. 8, "Every enactment must be construed as being remedial, and must be given such fair, large and liberal construction and interpretation as best ensures the attainment of its objects".

These principles must govern the interpretation of ss. 3(2)(a) and (2)(b), which are at issue in this appeal. They provide:

> 3. ...
>
> (2) The society shall ensure, for the purposes of subsection (1)(a), that legal services are available for a qualifying individual who
>
> (a) is a defendant in criminal proceedings that could lead to his imprisonment;
> (b) may be imprisoned or confined through civil proceedings;

B. The Requirements of Section 3(2)

48 To qualify under s. 3(2), an applicant for legal aid assistance must meet a two-part test. First, the proceedings must be either criminal or civil in nature. Second, the proceedings, if criminal, must possibly lead to imprisonment and, if civil, to imprisonment or confinement. Thus, contrary to the appellant's position that only the consequences are relevant, both the nature and the consequences of the proceedings must be considered in determining whether an applicant qualifies under s. 3(2). The appellant's position would render the words "criminal proceedings" and "civil proceedings" superfluous. This cannot have been the intention of the legislature. Rizzo Shoes, supra, makes it clear that all words in a statute must be given meaning.

C. Application of Section 3(2)

1. Section 3(2)(a): Criminal Proceedings

49 Are prison disciplinary hearings criminal proceedings that can lead to imprisonment? This question was considered in R. v. Shubley, [1990] 1 S.C.R. 3, albeit in a somewhat different context. The issue in that appeal was whether a prison disciplinary offence constituted an "offence" within the scope of s. 11(h) of the Canadian Charter of Rights and Freedoms. That subsection provides that a person found guilty and punished for an offence cannot be punished for it again. It was held by the majority that a conviction in a prison disciplinary proceeding did not constitute punishment for an "offence" within s. 11(h).

50 McLachlin J. writing for the majority applied the decision of Wilson J. in R. v. Wigglesworth, [1987] 2 S.C.R. 541. In that case, it was held that if a proceeding is to be barred by s. 11(h) the proceedings must, by their very nature, be either criminal proceedings or result in punishment which involves the imposition of true penal consequences. To ascertain whether proceedings by their very nature are criminal, it is necessary to examine the nature of the proceedings themselves rather than the act which gives rise to them. Wigglesworth confirmed that an act can have various aspects, each of which can give rise to proceedings. Both McLachlin J. in Shubley and Wilson J. in Wigglesworth quoted with approval the following passage from Cameron J.A. of the Saskatchewan Court of Appeal in R. v. Wigglesworth (1984), 7 D.L.R. (4th) 361, at pp. 365-66:

> A single act may have more than one aspect, and it may give rise to more than one legal consequence. It may, if it constitutes a breach of the duty a person owes to society, amount to a crime, for which the actor must answer to the public. At the same time, the act may, if it involves injury and a breach of one's duty to another, constitute a private cause of action for damages for which the actor must answer to the person he injured. And that same act may have still another aspect to it: it may also involve a breach of the duties of one's office or calling, in which event the actor must account to his professional peers.

McLachlin J. considered whether prison disciplinary hearings are criminal proceedings and concluded that they are not. Rather, their purpose is to maintain internal institutional discipline. At p. 20 she wrote:

> The internal disciplinary proceedings to which the appellant was subject lack the essential characteristics of a proceeding on a public, criminal offence. Their purpose is not to mete out criminal punishment, but to maintain order in the prison. In keeping with that purpose, the proceedings are conducted informally, swiftly and in private. No courts are involved.

51 McLachlin J. then asked whether the consequences attendant upon a finding of guilt in a prison disciplinary hearing were "true penal consequences". She quoted from Wilson J.'s decision in Wigglesworth in which Wilson J. defined true penal consequences as follows (at pp. 560-61):

> This is not to say that if a person is charged with a private, domestic or disciplinary matter which is primarily intended to maintain discipline, integrity or to regulate conduct within a limited private sphere of activity, he or she can never possess the rights guaranteed under s. 11. Some of these matters may well fall within s. 11, not because they are the classic kind of matters intended to fall within the section, but because they involve the imposition of true penal consequences. In my

> opinion, a true penal consequence which would attract the application of s. 11 is imprisonment or a fine which by its magnitude would appear to be imposed for the purpose of redressing the wrong done to society at large rather than to the maintenance of internal discipline within the limited sphere of activity. [Emphasis added.]

McLachlin J. found that the punishment imposed on Mr. Shubley by the prison disciplinary court -- close confinement for five days on a special diet that fulfils basic nutritional requirements -- did not constitute true penal consequences. At p. 23 she wrote:

> I conclude that the sanctions conferred on the superintendent for prison misconduct do not constitute "true penal consequences" within the Wigglesworth test. Confined as they are to the manner in which the inmate serves his time, and involving neither punitive fines nor a sentence of imprisonment, they appear to be entirely commensurate with the goal of fostering internal prison discipline and are not of a magnitude or consequence that would be expected for redressing wrongs done to society at large.

52 Wilson J. and I dissented, finding that "solitary confinement" was a true penal consequence coming within the second branch of the Wigglesworth test. In those reasons, I found that "close confinement" was a punishment distinct in kind from the incarceration to which the general prison population is subjected.

53 It was observed that the substantial and deleterious effects of solitary confinement are well documented and have long been known. At p. 9 of Shubley, I wrote:

> Prisons within prisons have been known to man as long as prisons have existed. As soon as castles had dungeons there were special locations within those dungeons for torture and for solitary confinement. The grievous effects of solitary confinement have been almost instinctively appreciated since imprisonment was devised as a means of punishment. Prisons within prisons exist today, exemplified by solitary confinement. [Emphasis added.]

Because of these substantial effects, solitary confinement is not simply an alternative manner of imprisonment in which a prisoner may serve his sentence. It is a punishment different in kind from general incarceration and reduces the residual liberties that even an incarcerated individual possesses. At pp. 9-10:

> Solitary confinement certainly cannot be considered as a reward for good conduct. It is, in effect, an additional violation of whatever residual liberties an inmate may retain in the prison context and should only be used where it is justified... . I would conclude, therefore, that solitary confinement must be treated as a distinct form of punishment and that its imposition within a prison constitutes a true penal consequence. [Emphasis added.]

54 However, I must follow the reasons of the majority in Shubley, supra. They are binding upon me and I must loyally follow them. Shubley has concluded that prison disciplinary hearings are not criminal proceedings. Under s. 3(2)(a) of the Legal Services Society Act, an applicant must meet both branches of the test. As the appellant fails the first part, that is, the nature of the proceedings, there is no reason to consider the second part, the consequences of the proceedings. The question as to whether the imposition of punitive dissociation (solitary confinement) constitutes imprisonment need not be answered.

2. Section 3(2)(b): Civil Proceedings

55 It now must be determined whether disciplinary proceedings that may result in solitary confinement come within the term "civil proceedings" in s. 3(2)(b). The definition of what is a "civil" proceeding has varied. The term is used most often simply as a counterpoint to "criminal", and it is this definition that the appellant submits is the correct meaning to be given to this section. That is, any proceeding that is not criminal is, by definition, civil. Section 3(2) is thus comprehensive and all proceedings that have the potential to lead to imprisonment or confinement fall within its ambit.

56 In Landry, the British Columbia Court of Appeal found that disciplinary hearings are a matter of internal administration. However the appellant submits that a prison disciplinary hearing cannot be so classified. He points to the absence of any contract or consensual agreement between an inmate and the penal institution in which he is incarcerated to support this position. It is argued that it is this absence which distinguishes the position of a prisoner from that of the members of a union or a professional body, such as a law society, who have willingly and specifically chosen to be bound by its by-laws and who can be punished for a breach of them.

57 It is significant that this position is supported by Dickson J. (as he then was) in his concurring judgment in Martineau v. Matsqui Institution Disciplinary Board, [1980] 1 S.C.R. 602 (Martineau No. 2), at p. 626:

> Parenthetically, this notion of contractual commitment to rules of internal discipline, a sort of volens, is sometimes advanced in support of the argument for a disciplinary exception. Whatever may be the force of that argument in other contexts, it is wholly inapplicable in a prison environment. [Emphasis added.]

58 As well, the appellant notes that the Legal Services Society considers the provision of legal services to prisoners facing post-suspension, post-revocation and detention hearings to be mandatory (White Paper: Core Services of the Legal Services Society of British Columbia (1994), at p. 33). He contends that there is no principled way to distinguish between these types of hearings and prison disciplinary hearings. In all these proceedings a prisoner's liberty interest is potentially at stake.

59 On the other hand, the respondent Legal Services Society submits that the fundamental criterion of civil proceedings is that they deal with rights of a "personal and private nature". Prison disciplinary hearings are not civil in nature for the purposes of s. 3(2)(b) because their basic purpose is to maintain the internal good order of the institution. The Legal Services Society distinguishes post-suspension, post-revocation and detention hearings from prison disciplinary hearings based on the private rights in issue; the offender has a private right to parole or statutory release that could be affected by the outcome of the post-suspension, post-revocation or detention hearing. In contrast, the Legal Services Society submits, the principal purpose of prison disciplinary hearings is the maintenance of internal good order and discipline within the penitentiary and not the adjudication of private rights or the provision for redress of the violation of private rights. In short, they are a fundamentally different type of proceeding.

60 The respondent the Attorney General of British Columbia submits that the word "proceedings" found in s. 3(2)(b) should properly be confined to court proceedings because of the formal procedures and rules of evidence that make legal training so useful in that forum.

61 I believe it is clear that the use of the word "civil" in s. 3(2)(b) must have a meaning beyond the adjudication of rights between two persons. To interpret "civil" in such a way is in effect to render s. 3 (2)(b) meaningless because imprisonment or confinement would rarely result from an adjudication of

rights between individuals. To reach such a conclusion would run counter to the principles of statutory interpretation set out in Rizzo Shoes, supra, since the term must be given a meaning that accords with the statute as a whole.

62 In Black's Law Dictionary (6th ed. 1990), "civil" is defined as follows: "Of or relating to the state or its citizenry. Relating to private rights and remedies sought by civil actions as contrasted with criminal proceedings" (p. 244). The definition of a "civil action" is an "[a]ction brought to enforce, redress, or protect private rights. In general, all types of actions other than criminal proceedings" (p. 245). This definition essentially accords with that offered by the Legal Services Society: "civil proceedings", as defined in s. 3(2)(b), refers to the enforcement, redress or protection of private rights.

63 However, the Legal Services Society is incorrect in its submission that no private right is in issue in prison disciplinary hearings. In Martineau No. 2, supra, and the trilogy of R. v. Miller, [1985] 2 S.C.R. 613, Cardinal v. Director of Kent Institution, [1985] 2 S.C.R. 643, and Morin v. National Special Handling Unit Review Committee, [1985] 2 S.C.R. 662, it has been specifically determined that incarcerated persons continue to possess a residual liberty interest that can be implicated by institutional action. For example in Miller, supra, at p. 637, Le Dain J. wrote: "In effect, a prisoner has the right not to be deprived unlawfully of the relative or residual liberty permitted to the general inmate population of an institution." (Emphasis added.) Although prisoners have been deprived in large measure of the liberty enjoyed by most citizens, they continue to possess the liberty enjoyed by the general penitentiary population.

64 The outcome of a prison disciplinary hearing could result in the imposition of a term in solitary confinement -- that is, a period of incarceration separate from the general penitentiary population. From this result it follows that a prisoner's private rights can be and are affected by a prison disciplinary hearing. Solitary confinement as punishment (punitive dissociation) can be imposed only after a quasi-judicial proceeding, namely a prison disciplinary hearing, has been held. As such it can be distinguished from solitary confinement intended simply to preserve order in the institution (administrative dissociation) or for the welfare of the inmate (protective custody). Thus, in my view a prison disciplinary hearing is a civil proceeding within the definition of s. 3(2)(b) of the Legal Services Society Act.

65 The consequences and effects of solitary confinement on prisoners demonstrate that it is not simply an alternative type of incarceration. Rather it clearly constitutes a further deprivation of a prisoner's residual liberty interests. The effects of solitary confinement were considered by Heald J. in McCann v. The Queen, [1976] 1 F.C. 570 (T.D.), a decision that was analysed in detail in M. Jackson, Prisoners of Isolation: Solitary Confinement in Canada (1983). Heald J. made it very clear that he accepted the prisoners' testimony as to the very disturbing effects solitary confinement had upon them. He found that the confinement of the plaintiff McCann and others in the solitary confinement unit of the British Columbia Penitentiary (since closed) amounted to cruel and unusual punishment in violation of s. 2(b) of the Canadian Bill of Rights.

66 Professor Jackson points out the difficulty of accurately describing or measuring the effects of solitary confinement on the human psyche, and the dearth of scientific literature detailing the psychological effects. Rather research has tended to focus upon the physical surroundings of prisoners confined in solitary. Professor Jackson writes at p. 64, "Dostoevsky is a surer guide than Glanville Williams in understanding what it is that we do, in the name of the criminal law, when we send men to the solitary-confinement cells". He notes that prisoner complaints stress the deeply depressing psychological repercussions even more than the physical deprivations of solitary confinement. Testifying in McCann, supra, Dr. George Scott, then the senior psychiatrist in the Canadian Penitentiary Service, reported that, for example, 11 percent of the prisoners in solitary confinement were involved in slashing incidents compared to 1 percent of the general population and that 6.4 percent had attempted suicide compared to 0.9 percent in the general prison population (McCann, at p. 599). Dr. Richard Korn, an expert in criminology and penology, while testifying in McCann, said that removing a prisoner for an extended period from the general prison population, that is, from the society in which he has a role, a job, and friends, "condemn[s him] to survive by techniques which would unfit him for that open society" (p. 592).

67 It is clear that solitary confinement is not simply a different yet similar form of incarceration than that experienced by the general prison population. Its effects can be serious, debilitating and possibly permanent. They serve to both emphasize and support the conclusion that solitary confinement constitutes an additional and a severe restriction on a prisoner's liberty.

68 It will be remembered that the Legal Services Society provides counsel for post-suspension, post-revocation and detention hearings. Yet in those circumstances where solitary confinement may be imposed as a result of serious disciplinary charges, the consequences flowing from a prison disciplinary hearing will probably be more severe, and at the very least as severe, as those that may flow from those hearings for which counsel is provided. There is no principled way to distinguish between these four different civil proceedings. It follows that prison disciplinary hearings are civil proceedings within the meaning of s. 3(2)(b).

69 The appellant has met the first part of the test laid out in s. 3(2)(b).

3. Section 3(2)(b): Confinement or Imprisonment

70 The second part of the test that the appellant must meet to succeed in this appeal is to show that he "may be imprisoned or confined" as a result of the prison disciplinary hearing. As a result of being charged under the Corrections and Conditional Release Act, the appellant spent a total of 38 days in solitary confinement.

71 In Shubley, supra, it was determined that "close confinement" is not imprisonment. At p. 23 McLachlin J., for the majority, writes:

> I conclude that the sanctions conferred on the superintendent for prison misconduct do not constitute "true penal consequences" within the Wigglesworth test. Confined as they are to the manner in which the inmate serves his time, and involving neither punitive fines nor a sentence of imprisonment, they appear to be entirely commensurate with the goal of fostering internal prison discipline and are not of a magnitude or consequence that would be expected for redressing wrongs done to society at large. [Emphasis added.]

Imprisonment is clearly a true penal consequence within the meaning given the term in Wigglesworth, supra. By inference, then, if solitary confinement is not a true penal consequence, it cannot be equated with imprisonment that is separate and different from the incarceration already experienced by an inmate. The question that remains is whether solitary confinement is "confinement" within the meaning of s. 3(2)(b).

72 It is noteworthy that the Legal Services Society concedes that the prison disciplinary hearings faced by the appellant may lead to his confinement pursuant to s. 3(2)(b). The Attorney General of British Columbia disputes this concession. He submits, instead, that s. 3(2)(b) is intended to provide legal services to someone who faces a civil proceeding "which involves the exercise of the power to imprison or confine to which that person is not normally subject. Because prisoners are already incarcerated, the power to imprison or confine has already been exercised" (emphasis added). In effect the Attorney General contends that a currently incarcerated person cannot be confined.

73 This assumption, with respect, must be rejected. Martineau No. 2, supra, together with the trilogy of Miller, supra, Morin, supra, and Cardinal, supra, make it very clear that incarcerated persons retain a residual liberty interest. This interest can be defined as the right to be treated in the same way as other members of the general prison population. Although these cases dealt with the duty resting upon prison officials to act fairly when disciplining prisoners, implicit in the reasons is the acknowledgment that prisoners retain certain enforceable private rights. See for example the following statement by Le Dain J. in Miller, supra, at p. 641:

> Confinement in a special handling unit, or in administrative segregation as in Cardinal, is a form of detention that is distinct and separate from that imposed on the general inmate population. It involves a significant reduction in the residual liberty of the inmate. It is in fact a new detention of the inmate, purporting to rest on its own foundation of legal authority. [Emphasis added.]

Le Dain J. carefully distinguished between "form[s] of confinement or detention in which the actual physical constraint or deprivation of liberty ... is more restrictive or severe than the normal one in an institution" and "the mere loss of certain privileges" (p. 641). This statement is in accord with his writing in Cardinal, supra, at p. 653 that confinement in administrative dissociation or in a special handling unit is a "significantly more restrictive and severe for[m] of detention than that experienced by the general inmate population".

74 Section 44(1)(f) of the Corrections and Conditional Release Act, provides that an inmate found guilty of a "serious disciplinary offence" may face "segregation from other inmates for a maximum of thirty days". It is clear from the trilogy of cases that segregation, whether administrative as in Cardinal or punitive as in this appeal, is a form of incarceration more restrictive than the incarceration experienced by the general prison population. It results in a deprivation of that residual liberty interest possessed by prisoners within our penitentiaries. This deprivation represents a further confinement of the appellant in a prison within a prison. It certainly constitutes a "confinement" within the meaning of s. 3 (2)(b).

75 Solitary confinement has in the past and will undoubtedly have a significant and deleterious effect upon prisoners. Nonetheless, it is a punishment that may well be required in order to protect other prisoners and custodians and to ensure an appropriate standard of discipline in the penitentiary. Maintaining order in a medium or maximum security setting must at times be daunting to say the least. Yet the maintenance of order is essential for all within its confines. It is because of the possible effects and consequences of solitary confinement that a fair hearing is required. Fairness requires that the prisoner be provided with legal counsel.

76 The concurring judgment of MacGuigan J.A. in Howard v. Stony Mountain Institution, [1984] 2 F.C. 642, provides some useful guidance as to the necessity of legal counsel in prison disciplinary hearings. He considered the presence of a lawyer for the prisoner to be essential in hearings in which an inmate faced the possibility of losing earned remission. At p. 688 he wrote:

> In sum, other than, perhaps, in fact situations of unique simplicity, I cannot imagine cases where a possible forfeiture of earned remission would not bring into play the necessity for counsel. Indeed, in my view the probability that counsel will be required for an adequate hearing on charges with such consequences is so strong as to amount effectively to a presumption in favour of counsel, a departure from which a presiding officer would have to justify. [Emphasis added.]

A prisoner earns remission for his good behaviour in prison. He can lose it as the result of disciplinary measures taken pursuant to the Corrections and Conditional Release Act. Earned remission effectively shortens the time a prisoner spends in prison but does not affect the manner in which he spends his time in prison.

77 By way of comparison, solitary confinement with its very real deprivation of privileges can have a significant impact on the manner in which a prisoner is incarcerated, as well as affecting his right to earn remission. Representation by counsel obviously assumes an even greater importance when solitary confinement may be imposed as a punishment.

78 By way of summary the following can be stated:

1. As a result of the serious disciplinary charge, the appellant faced the possibility of punishment by way of solitary segregation.
2. The disciplinary proceedings are civil proceedings within the meaning of that term as it is used in s. 3(2)(b) of the Legal Services Society Act.
3. Solitary segregation constitutes confinement as that term is used in s. 3(2)(b).
4. It follows that the appellant has met the requirements of s. 3(2)(b) of the Legal Services Society Act and is entitled to be provided with the services of a lawyer for the disciplinary hearing.
5. As a result of the conclusions outlined in these reasons I cannot, with the greatest of respect, agree with the decision of the British Columbia Court of Appeal in Landry, supra.

V. Costs

79 The appellant seeks his costs in this Court and in the courts below on a solicitor-client basis. It is well settled that solicitor-client costs are unusual. They should not be awarded unless there is something in the behaviour of the losing party that takes the case outside the ordinary. See K. Roach, Constitutional Remedies in Canada (loose-leaf), at para. 11.860. For example, solicitor-client costs were awarded when this Court was of the opinion that the unsuccessful party should not have pursued the litigation or the unsuccessful party had been unreasonable in some other way. See Palachik v. Kiss, [1983] 1 S.C.R. 623. They have also been awarded when a respondent without financial resources who had not wished to pursue the case to this Court was successful in a case which was of considerable importance to a large group or class: Roberge v. Bolduc, [1991] 1 S.C.R. 374. An exception was also made where a respondent public interest group was successful. See Friends of the Oldman River Society v. Canada (Minister of Transport), [1992] 1 S.C.R. 3, at p. 80, in which La Forest J. awarded solicitor-client costs "given the Society's circumstances and the fact that the federal Ministers were joined as appellants even though they did not earlier seek leave to appeal to this Court".

80 It is certainly true that in the highest and best traditions of the Bar the appellant's counsel has worked long, diligently and with great skill to represent an indigent appellant. He is deserving of high praise. Nonetheless, there is nothing in this case or in the behaviour of the Legal Services Society or the Attorney General of British Columbia which would warrant an award of solicitor-client costs. Therefore the appellant should have his party and party costs throughout.

VI. Disposition

81 The appellant is a "qualifying individual" within the provision of s. 3(2)(b) of the Legal Services Society Act and is entitled to the requisite legal services for his disciplinary hearing. The appeal is therefore allowed with costs throughout these proceedings.

Solicitors for the appellant: Conroy & Company, Abbotsford, B.C.

Solicitors for the respondent the Legal Services Society: MacAdams Law Firm, Abbotsford, B.C.; Legal Services Society, Vancouver.
Solicitor for the respondent the Attorney General of British Columbia: The Ministry of the Attorney General, Vancouver.

cp/d/qlhbb

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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.

[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.)

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.

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

15

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.

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

16

Case Name:
ROI Fund Inc. v. Gandi Innovations Ltd.

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

[2011] O.J. No. 3827

2011 ONSC 5018

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

2011 CarswellOnt 8590

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

Court File No. 09-CL-8172

Ontario Superior Court of Justice
Commercial List

F.J.C. Newbould J.

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

(62 paras.)

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

Motion by the Monitor for the Gandi Group for advice and directions regarding indemnity claims made against the Group. The Gandi Group was under creditor protection. The Monitor was appointed in May

2009. The business and assets of the Group were sold with court approval. The Monitor held the proceeds for eventual distribution to unsecured creditors pursuant to a plan of compromise and arrangement. The indemnity claims arose from the 2007 reorganization of the Group's business structure. The claimants were officers and board members of Gandi Holdings. A lender advanced $75 million by way of debt and equity to the Group. The indemnity claimants were party to the advance in their personal capacities. In 2009, the lender commenced arbitration proceedings against the claimants for the total of the advance. The claimants asserted an entitlement to indemnification by the Group in respect of any award of damages which may be made against them in the arbitration together with all legal fees incurred in defending the arbitration. The claimants' proofs of claim relied on indemnity provisions set out in the limited liability company agreement and a separate indemnification made by Gandi Holdings at the time of the lender's advance. In 2011, the Monitor disallowed the claims on the basis that any claim would be made solely against Gandi Holdings rather than against other entities in the Group.

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

Statutes, Regulations and Rules Cited:

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

Counsel:

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

Mathew Halpin and Evan Cobb, for TA Associates Inc.

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

ENDORSEMENT

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

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

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

Arbitration proceedings and indemnity claims

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

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

(i) an equity investment in the amount of US $50 million made pursuant to the terms of a Membership Interest Purchase Agreement in respect of Gandi Holdings dated as of September 12, 2007 made between, among others, Gandi Holdings, TA Associates and the Claimants in their personal capacities; and

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

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

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

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

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

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

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

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

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

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

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

Issues

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

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

Discussion

(a) Indemnity agreements

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

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

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

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

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

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

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

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

24 The date of September 12, 2007, said to be the date that all of the entities in the Gandi Group signed indemnities in favour of each of the claimants, was the date of the investment by TA Associates in which it purchased a membership interest in Gandi Holdings only. Representatives of TA Associates received identical indemnities from Gandi Holdings. There is no evidence that any indemnities from any of the other Gandi Group entities were made at that time. To the contrary, the Membership Interest Purchase Agreement under which TA Associates purchased its membership interest in Gandi Holdings contained as a condition to closing a requirement that Gandi Holdings sign an indemnification agreement. The indemnification was only to be given by Gandi Holdings. There was no requirement for an indemnity to be given by any other entity in the Gandi Group,.

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

(b) Memorandum and articles of Gandi Hold Co

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

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

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

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

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

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

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

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

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

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

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

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

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

(d) Other Gaudi Group entities

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

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

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

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

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

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

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

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

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

45 Whether or not Ms. Garay was a disinterested or proper member of the board of management of Gandi Holdings, the minute states that she voted to follow the advice of corporate counsel. At the next

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

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

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

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

48 Pursuant to the terms of the Initial Order, the Monitor was required to approve all expenditures over $10,000 before payment was made. The Monitor approved payment of legal fees to counsel for the Gandi Group on the general understanding that such fees were incurred by the Gandi Group in connection with the Gandi Group's insolvency proceeding and for general corporate work for the Gandi Group.

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

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

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

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

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

53 Section 6(8) of the CCAA provides:

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

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

"equity claim" means a claim that is in respect of an equity interest, including a claim for, among others,

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

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

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

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

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

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

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

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

> This treatment also has been held to encompass fraudulent misrepresentation claims advanced by a shareholder seeking to recover his investment: *Re Blue Range Resource Corp.*, [2000] A.J. No. 14. In that case, Romaine J. held that the alleged loss derived from and was inextricably intertwined with the shareholder interest. Similarly, in the United States, the Second Circuit Court of Appeal in *Re Stirling Homex Corp.* concluded that shareholders, including those who had allegedly been defrauded, were subordinate to the general creditors when the company was insolvent.

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

Order

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

F.J.C. NEWBOULD J.

cp/e/qlcct/qlvxw/qlced/qlhcs

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

90 C.B.R. (5th) 141

2012 CarswellOnt 103

211 A.C.W.S. (3d) 264

Docket: M40553

Ontario Court of Appeal
Toronto, Ontario

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

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

(13 paras.)

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

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

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

Statutes, Regulations and Rules Cited:

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

Counsel:

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

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

Harvey Chaiton and Maya Poliak, for the Monitor.

ENDORSEMENT

The following judgment was delivered by

THE COURT:--

Overview

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

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

a) whether the moving parties (the Claimants) are entitled to indemnity from all of the entities which comprise the Gandi Group, and, if so,
b) whether those indemnification claims are "equity" or "non-equity" claims for

purposes of the CCAA (non-equity claims have priority).

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

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

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

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

4 The Claimants seek leave to appeal from that order.

5 We deny the request.

Analysis

The Test

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

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

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

7 The Claimants do not meet this stringent test here.

The Indemnification Issue

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

The Subordination Issue

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

The "Equity Claim" Issue

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

11 "Equity" claims are subsequent in priority to non-equity claims by virtue of s. 6(8) of the CCAA. What constitutes an "equity claim" is defined in s. 2(1) and would appear to encompass the indemnity claims asserted by the Claimants here. Those provisions of the Act did not come into force until shortly after the Gandi Group CCAA proceedings commenced, however, and therefore do not apply in this situation. Newbould J. relied upon previous case law suggesting that the new provisions simply incorporated the historical treatment of equity claims in such proceedings: see, for example, *Re Nelson Financial Group Ltd.*, 2010 ONSC 6229 (CanLII), (2010), 75 B.L.R. (4th) 302, at para. 27 (Pepall J.). He therefore concluded that TA Associates was in substance attempting to reclaim its equity investment in the Gandi Group through the arbitration proceedings and that the Claimants' indemnity claims arising from that claim must be equity claims for CCAA purposes as well.

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

Disposition

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

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

cp/e/qllxr/qljxr/qlmll/qlana/qlcas

17

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.

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 <u>lawful</u> discretion of and for any <u>lawful</u> 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 even if 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, for that purpose, 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 not 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 not 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.

cp/e/qw/qllls/qlgpr

18

Sullivan on the Construction of Statutes

Fifth Edition

by

Ruth Sullivan

Professor of Law
University of Ottawa

(2008)

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merely formal, to improve the formulation of the law without changing its substance, or it may be substantial, designed to change the content of the law.

Once the significance of each successive change has been established, the interpreter can trace the intention of the legislature over time, up to the relevant moment. In so far as a change is merely stylistic, the meaning and purpose of the previous version remain constant. If substantive change has occurred, the interpreter must determine the purpose and scope of the change. In the latter case, there is a range of possibility, from a sudden reversal of policy to a slowly evolving trend.

Presumption that change is purposeful. It is presumed that amendments to the wording of a legislative provision are made for some intelligible purpose: to clarify the meaning, to correct a mistake, to change the law.[15] A legislature would not go to the trouble and expense of amending a provision without any reason. As Lord MacMillan wrote in *D.R. Fraser and Co. v. Canada (Minister of National Revenue — M.N.R.)*:

> When an amending Act alters the language of the principal statute, the alteration must be taken to have been made deliberately.[16]

Although the presumption of purposeful change is strong, it is not irrebuttable. On occasion a court is forced to conclude that a particular amendment had no intelligible purpose and in fact was a drafting error.[17]

It is presumed far less strongly that the purpose of amending legislation is to bring about a *substantive* change in the law.[18] This presumption is grounded in historical British practice. Until recently, the resources of the British Parliament were not expended on improving the clarity or consistency of the statute book; if amendments were introduced, their purpose was to change the substance of the law. In Canada, where making formal improvements to the statute book is a minor industry,[19] the presumption of substantive change is weak and easy to rebut.

15 This follows from the presumption against tautology, discussed in Chapter 7, at pp. 210ff.

16 [1948] J.C.J. No. 3, [1949] A.C. 24, at 33 (P.C.). See also *Klippert v. R.*, [1967] S.C.J. No. 71, [1967] S.C.R. 822, at 834-35 (S.C.C.).

17 For discussion of drafting errors, see Chapter 6, at pp. 172ff.

18 See *Quebec (Commission des droits de la personne et des droits de la jeunesse) v. Montréal (City)*, [2000] S.C.J. No. 24, [2000] 1 S.C.R. 665, at para. 60 (S.C.C.); *Peralta v. Ontario*, [1985] O.J. No. 2304, 49 O.R. (2d) 705, at 716 (Ont. C.A.), affd [1988] S.C.J. No. 92, [1988] 2 S.C.R. 1045 (S.C.C.); *Mahone Bay (Town) School Commrs.*, [1979] N.S.J. No. 609, 101 D.L.R. (3d) 87, at 90-91 (N.S.C.A.); *Ottawa (City) v. Hunter*, [1900] S.C.J. No. 54, 31 S.C.R. 7, at 10 (S.C.C.).

19 Canadian practice differs from British practice in three related respects: first, unlike the British Parliament, Canadian legislatures have engaged in periodic statute revisions for more than a century; second, much Canadian legislation is bilingual and this has created a need for frequent correction of minor discrepancies; third, Canadian drafters (most notably Elmer Driedger) took the lead in developing a new style of drafting and introducing new drafting conventions. Each of these practices entails making purely formal changes to the statute book.

The presumption of substantive change may also be influenced by s. 45 of the federal *Interpretation Act*[20] and comparable provisions in provincial Interpretation Acts.[21] The relevant parts of s. 45 provide:

> 45. ...
>
> (2) The amendment of an enactment shall not be deemed to be or to involve a declaration that the law under that enactment was or was considered by Parliament . . . to have been different from the law as it is under the enactment as amended.
>
> (3) The repeal or amendment of an enactment in whole or in part shall not be deemed to be or to involve any declaration as to the previous state of the law.

These provisions do not affect the presumption that changes to the wording of legislation are purposeful. Nor do they preclude the court from acknowledging that, in principle at least, the foremost purpose of amendment is to bring about a substantive change in law. They do, however, remind the courts that amendments do not necessarily have this purpose.

Substantive change is intended. When two successive versions of a provision are compared to one another, it is often apparent that a substantive change was intended. The judgment of the Federal Court of Appeal in *Crupi v. Canada (Employment and Immigration Commission)*[22] offers an example. In that case the court was concerned with s. 45 of the *Unemployment Insurance Act* which denied insurance benefits to inmates of "any prison or similar institution". The issue was whether this language applied to a person remanded to a maximum security psychiatric institution for observation pending trial. In determining that it did not, the majority of the court drew attention to the wording of s. 45 prior to amendment. In its previous version this section denied insurance benefits to inmates of "any prison or penitentiary or an institution supported . . . out of public funds". Heald J.A. wrote:

> Clearly the former section 45 had much wider parameters than the present section 45.... [B]y this amendment, hospitals and other publicly funded institutions have been removed from the reach of section 45 which is now restricted to prisons and institutions similar to prisons. The change in the language used in section 45 is clearly purposive and must be presumed to have some significance.[23]

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20 R.S.C. 1985, c. I-21.

21 R.S.A. 2000, c. I-8, s. 37(1)(b), (2); R.S.B.C. 1996, c. 238, s. 37(1), (2); C.C.S.M. c. I80, s. 48(1), (2), (3); R.S.N.B. 1973, c. I-13, s. 11(2), (3); R.S.N.L. 1990, c. I-19, s. 31(2), (3); S.O. 2006, c. 21, s. 56(1)(2); R.S.P.E.I. 1988, c. I-8, s. 34(1)(b), (2); S.S. 1995, c. I-11.2, s. 36(1); R.S.N.W.T. 1988, c. I-8, s. 37(1), (2); R.S.Y. 2002, c. 125, s. 25(2), (3). The Acts of Nova Scotia and Quebec contain no comparable provisions.

22 [1986] F.C.J. No. 204, [1986] 3 F.C. 3 (F.C.A.). For other examples, see also *McGuigan v. R.*, [1982] S.C.J. No. 9, [1982] 1 S.C.R. 284, at 651-54 (S.C.C.); *N.B. v. Estabrooks Pontiac Buick Ltd.*, [1982] N.B.J. No. 397, 44 N.B.R. (2d) 201, at 216-20 (N.B.C.A.).

23 *Ibid.*, at 10.

19

In re: MID-AMERICAN WASTE SYSTEMS, INC., et al., Debtors.

Chapter 11, Case No. 97-104 (PJW) (Substantively Consolidated)

UNITED STATES BANKRUPTCY COURT FOR THE DISTRICT OF DELAWARE

228 B.R. 816; *1999 Bankr. LEXIS 27*; *33 Bankr. Ct. Dec. 958*

January 13, 1999, Decided

DISPOSITION: [**1] O&D Claimants administrative expense priority claims disallowed and the Claimants' claims subordinated pursuant to *§ 510(b)* and treated as Class 7 claims in MAWS's Plan.

COUNSEL: Laurie Selber Silverstein, William A. Hazeltine, Potter Anderson & Corroon LLP and Neil B. Glassman, Scott D. Cousins, The Bayard Firm, Wilmington, DE, for Mid-American Waste Systems, Inc.

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JUDGES: Peter J. Walsh, J.

OPINION BY: Peter J. Walsh

OPINION

[*818] MEMORANDUM OPINION

Peter J. Walsh

J.

Before the Court are the objections (Doc. # 760, 761, 795) of reorganized debtor Mid-American Waste Systems, Inc. ("MAWS") to (i) the proofs of claim filed by MAWS's former officers and directors John D. Peckskemp, R. Jay Roberts, Christopher L. White, Richard A. Nidders, Jr., and Dennis P. Wilburn (collectively the "O&D Claimants"), (ii) the proof of claim of NatWest Capital Markets Limited ("NatWest"), and (iii) the proof of claim of Donaldson, Lufkin, & Jenerette ("DLJ", and together with the O&D Claimants and Natwest, the "Claimants"). MAWS objects to the claims on the grounds that they should be subordinated pursuant to *§ 510(b) of the Bankruptcy Code,* [1] or, alternatively, they should be disallowed and expunged pursuant to *§ 502(e)(1)(B)*. In addition, MAWS objects to the O&D Claimants' claims on the ground that their claims are not allowable as administrative expense claims under *§ 503(b)(1)(A)*. For the reasons given below, I find that the Claimants' claims [**3] should be treated as unsecured subordinated claims pursuant to *§ 510(b)*. Because subordinated claims under MAWS' liquidating plan are not entitled to any distribution, I need not reach the alternative issue of whether the claims should be disallowed pursuant to *§ 502(e)(1)(B)*.

1 All references to "§ " refer to a section of the Bankruptcy Code, *11 U.S.C. § 101 et seq.*

FACTS

MAWS was formed in December 1985 to acquire and operate solid waste collection operations and landfills. MAWS commenced operations in January 1986 and rapidly expanded through the acquisition of more than 127 collection operations, transfer stations, and preexisting collection services.

In May 1994, MAWS obtained a $ 75 million unsecured credit facility provided by three lenders. As contemplated by the facility, MAWS effected a public issuance of $ 175 million of 12.25% Senior Subordinated Notes due 2003 (the "Notes"). Pursuant to an underwriting agreement dated May 17, 1994, NatWest and DLJ served as underwriters [**4] for MAWS in connection with the offering of the Notes. Section 6 of the underwriting agreement contains an indemnification clause which provides that

> (a) The Issuers [i.e., MAWS], jointly and severally, agree to indemnify and hold harmless [DLJ and NatWest] to the fullest extent lawful, from and against any and all losses, claims, damages, liabilities, judgments, actions and expenses (including without limitation and as incurred, reimbursement of all reasonable costs of investigating, preparing, pursuing or defending any claim or action . . . commenced or threatened, including the reasonable fees and expenses of counsel to [DLJ and NatWest]) directly or indirectly caused by, related to, based upon, arising out of or in connection with any untrue statement or alleged untrue statement of a material fact contained in the Registration Statement . . . or the Prospectus. . . .
>
> (b) [DLJ and NatWest] shall have the right to employ its own counsel in any such action and the fees and expenses of such counsel shall be paid, as incurred, by the Issuers (regardless of whether it is ultimately determined that [either DLJ or NatWest] is not entitled to Indemnification [*819] hereunder). [**5] The Issuers shall not, in connection with any one such action or proceeding or separate but substantially similar or related actions or proceedings in the same jurisdiction arising out of the same general allegation or circumstances, be liable for the reasonable fees and expenses of more than one separate firm of attorneys . . . at any time for [DLJ or NatWest].

In early 1996, following allegations of wrongful conduct by existing management, MAWS conducted a review of its operations and financial condition and discovered that its assets were impaired by approximately $ 186 million and that closure and postclosure costs had been underaccrued by $ 19 million. Such impairment and underaccruals were in addition to $ 196 million of impairments and losses and $ 70 million in underaccrued closure and postclosure expenses recorded during the 1995 fiscal year. Prior to its Chapter 11 filing, MAWS took write downs on their financial statements of over $ 470 million to account for overstatements of asset values and understatements of amortization costs and accrued closure and postclosure obligations.

During the period January 17, 1997 through April 16, 1997, certain holders of the Notes [**6] commenced the following actions against certain of the Claimants and others:

> (i) *Federated Management et al. v. Coopers & Lybrand, LLP*, Court of Common Pleas, Franklin County, Ohio, Case No. 97CVH-01-2196, filed January 24, 1997 (the "Ohio Lawsuit");
>
> (ii) *Canyon Capital Management,*

L.P. et al. v. Coopers & Lybrand, LLP et al., United States District Court for the Southern District of Ohio, Eastern Division, Case No. C2 97-419, filed April 14, 1997 ("Canyon I");

(iii) *Canyon Capital Management, L.P. et al. v. Coopers & Lybrand, LLP et al.*, Court of Common Pleas, Franklin County, Ohio, Case No. 97CVH04-4481, filed April 16, 1997 ("Canyon II").

Each lawsuit named former officers and directors Christopher White, Dennis P. Wilburn, and Richard A. Widders as defendants. The Ohio Lawsuit was later amended to add former director Richard Jay Roberts as a defendant. The Ohio Lawsuit also named DLJ and NatWest as defendants. [2]

2 Several of the proofs of claim refer to *Corporate High Yield Fund, Inc. et al. v. Coopers & Lybrand, LLP et al.*, United States District Court for the District of New Jersey, Civil Action No. 97-325 (AJL), filed January 17, 1997 (the "New Jersey Lawsuit"), which had named DLJ and NatWest as defendants. Pursuant to a stipulation of settlement, the New Jersey Lawsuit was dismissed with prejudice and without any payment by the O&D Claimants to the plaintiffs in the action.

[**7] The plaintiffs allege causes of action for false representations and omissions in the registration statement, prospectus and financial statements filed with the SEC in connection with the sale of the Notes. The plaintiffs generally assert claims under Ohio securities laws, common law fraud, aiding and abetting common law fraud, negligent misrepresentation, breach of contract, breach of fiduciary duty/acting in concert, negligence and violations of sections 11, 12, 15 and 17 of the Securities Act of 1933. The Canyon I complaint also alleges causes of action pursuant to sections 10(b), 18 and 20(a) of the Securities Exchange Act of 1934 and SEC *Rule 10b-5*. The plaintiffs seek rescission of the plaintiffs' purchases of the Notes, unliquidated actual damages and punitive damages. The Canyon I complaint also seeks disgorgement of profits. No judgment has been rendered in any of these lawsuits and they are still pending.

On April 22, 1997, certain equityholders commenced the following action against, *inter alia*, former officers and directors White, Wilburn and Widders:

Bovee et al. v. Coopers & Lybrand, LLP et al., United States District Court for the Southern District [**8] of Ohio, Eastern Division, Case No. C2 97-449, filed April 22, 1997 (the "Equityholders Lawsuit", and together with the Ohio Lawsuit, the Canyon I Lawsuit, and the Canyon II Lawsuit, the "Securities Litigation").

The Equityholders Lawsuit is a class action complaint brought by purchasers of MAWS common stock during the period April 4, 1995 [*820] through January 21, 1997. The complaint alleges that the defendants either knowingly or recklessly published or disseminated false financial statements and data causing the plaintiffs to buy MAWS stock at artificially high prices and suffer losses. The complaint asserts causes of action for violations of sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and SEC *Rule 10b-5*, as well as for negligence and negligent misrepresentation.

On January 21, 1997, MAWS and its thirty-one subsidiaries filed voluntary petitions for relief under Chapter 11 of the Bankruptcy Code. On that date, MAWS filed a motion for approval of the sale of substantially all of their assets to USA Waste Services, Inc. That sale was subsequently approved, and thereafter the Court approved MAWS's Amended Joint Liquidating Plan of Reorganization (the "Plan"). [**9] The Plan provides for payment in full of class 1 administrative claims, partial payment for class 4 unsecured claims, and no payout to holders of class 7 subordinated claims. (Doc. # 541 at 18-25)

The O&D Claimants assert indemnification claims based on both MAWS's Certificate of Incorporation and on Delaware corporation law, 8 *Del. C. § 145(c)*. The Certificate of Incorporation indemnification provision reads:

The corporation will indemnify or agree to indemnify any person who was or is a party, or is threatened to be made a party to any threatened, pending, or completed action or suit by or in the right of the corporation to procure a judgment in its favor by reason of the fact that he is or was a director, officer, employee, or agent

> of the corporation, or is or was serving at the request of the corporation as director, trustee, officer, employee, or agent of another corporation (including a subsidiary of this corporation), domestic or foreign, nonprofit or for profit, partnership, joint venture, trust, or other enterprise against expenses, including attorneys' fees, actually and reasonably incurred by him in connection with the defense or settlement of such action [**10] or suit if he acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interest of the corporation, except that no indemnification shall be made in respect to any claim, issue, or matter as to which such person shall have been adjudged to be liable to the corporation unless, and only to the extent that, the Court of Chancery, or the court in which such action or suit was brought shall determine upon application that, despite the adjudication of liability, but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses as the Court of Chancery or other such court shall deem proper.

(Doc. # 761 at 7)

The O&D Claimants were senior members of the MAWS management team. Several of the O&D Claimants were never employed postpetition, having resigned prior to MAWS's bankruptcy filing. All of the facts and circumstances which form the basis of the claims against the O&D Claimants in the Securities Litigation occurred prior to MAWS's bankruptcy filing. Each O&D Claimant lists his claim as an administrative expense claim.

NatWest and DLJ filed proofs of claim which seek, as general unsecured [**11] claims, (i) unliquidated damages pursuant to paragraph 6 of the underwriting agreement and section 11(f) of the Securities Act of 1933; and (ii) damages on account of fees, including attorneys' fees, and costs and expenses of defending the Securities Litigation that have already accrued (for NatWest, a liquidated amount of $ 455,283.22; for DLJ, a liquidated amount of $ 207,829.83) and that have not yet accrued.

MAWS objects to the Claimants' claims on the grounds that the claims should be subordinated pursuant to *§ 510(b) of the Bankruptcy Code*, or, alternatively, that they should be disallowed and expunged pursuant to *§ 502(e)(1)(B)*. (Doc. # 760, 761, 795) In addition, MAWS objects to the O&D Claimants' claims on the ground that their claims are not allowable as administrative expense claims under *§ 503(b)(1)(A)*. The Claimants filed responses (Doc. # 802, 805, 837), MAWS filed replies thereto (Doc. # 860, 867, 868), and the Court heard oral argument on the matter.

[*821] DISCUSSION

The O&D Claimants' Claims as Administrative Expense Claims

The O&D Claimants seek administrative expense priority for their indemnification claims against MAWS. They claim that, citing [**12] *Avellino & Bienes v. M. Frenville Co. (In re M. Frenville Co.), 744 F.2d 332 (3d Cir. 1984)*, "a claim against a debtor for indemnification or contribution arising from litigation commenced against the creditor postpetition constitutes an administrative claim." (Doc. # 802 at 6) Although the O&D Claimants seek an administrative expense priority payment, their brief does not discuss, or even identify *§ 503(b)*--the governing statutory provision.

Section 503(b)(1)(A) defines administrative expenses as including "the actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case." It is well established that a company's duty to indemnify officers is a form of compensation. *Christian Life Center Litig. Defense Comm. v. Silva (In re Christian Life Center), 821 F.2d 1370, 1373 (9th Cir. 1987)*("A corporation's duty to indemnify its officer, whether conferred by statute or by contract, is a form of compensation for the officer's services.") (citing *In re Baldwin-United Corp., 43 B.R. 443, 454-56 (S.D. Ohio 1984))*; *see also In re Philadelphia Mortgage Trust, 117 B.R. 820, 827 (Bankr.* [**13] *E.D. Pa. 1990)*; *In re Consolidated Oil & Gas, Inc., 110 B.R. 535, 537 (Bankr. D. Colo. 1990)*; *In re Amfesco Indus., Inc., 81 B.R. 777, 784 (Bankr. E.D.N.Y. 1988)*.

To establish administrative priority under *§ 503(b)(1)(A)*, the O&D Claimants must demonstrate that the claimed expenses (i) arose out of a postpetition transaction with the debtor-in-possession and (ii) directly and substantially benefitted the estate. *Microsoft Corp. v. DAK Indus., Inc. (In re DAK Indus., Inc.), 66 F.3d 1091, 1094 (9th Cir. 1995)*; *In re Molnar Bros., 200 B.R. 555, 559 & n.3 (Bankr. D.N.J. 1996)*. As the Second Circuit has stated:

> An expense is administrative only if it arises out of a transaction between the creditor and the bankrupt's trustee or debtor in possession and "only to the extent that the consideration supporting the claimant's right to payment was both supplied to and beneficial to the debtor-in-possession in the operation of the business." A debt is not entitled to priority simply because the right to payment arises after the debtor in possession has begun managing the estate.

Trustees of Amalgamated Ins. Fund v. McFarlin's, Inc., 789 F.2d 98, 101 (2d Cir. [**14] *1986)* (quoting *In re Mammoth Mart, Inc., 536 F.2d 950, 954 (1st Cir. 1976))* (citations omitted).

I do not perceive a postpetition transaction between MAWS and the O&D Claimants as having occurred here. The O&D Claimants were each employed prepetition by MAWS. The O&D Claimants' conduct which forms the basis for the Shareholder Litigation all arose out of their prepetition activities as officers and/or directors of MAWS. The indemnification provisions upon which the O&D Claimants base their claims were in place during the entire prepetition relevant period and covered the O&D Claimants throughout the prepetition period in which the conduct at issue occurred.

An indemnification claim by an officer or director based on that officer's or director's prepetition services is not a claim on account of "services rendered after the commencement of a case" that is entitled to administrative expense priority. Instead, the O&D Claimants' indemnification claims are merely claims for prepetition compensation for services rendered, not unlike salary or other benefits. *See, e.g., Christian Life, 821 F.2d at 1373* (holding that officers' indemnity/contribution claims for litigation costs were [**15] not an administrative expense because litigation was based on prepetition services and conduct); *Baldwin-United, 43 B.R. at 454-56* (holding that directors and officers' claims based on debtor's bylaws for indemnity of costs of defending against allegations of misconduct during their tenure on prepetition debtor's board of directors were not compensable as administrative claims); *Philadelphia Mortgage, 117 B.R. at 828* ("Claims of corporate officers for indemnification and compensation [*822] for pre-petition actions based upon corporate by-laws or resolutions . . . have consistently been denied administrative status due to findings by courts that such claims are pre-petition claims because the acts or services which gave rise to them were performed pre-petition."); *Amfesco, 81 B.R. at 781* ("All of the operative facts, legal relationships, and conduct of the Applicants upon which is based the threatened litigation occurred prepetition. . . . Any duty of the Debtors to indemnify the Applicants arises from services provided to the pre-petition Corporation not for services rendered post-petition to the Debtors-in-Possession."); *Consolidated Oil, 110 B.R. at 537* (holding that corporate [**16] officers and directors were not entitled to administrative expense priority on their right to indemnification for legal fees founded on state law, the debtor's articles of incorporation and bylaws, and employment contracts where the officers and directors performed no postpetition services for the debtor and the litigation, commenced postpetition, was based on prepetition conduct); *cf. In re Heck's Properties, Inc., 151 B.R. 739, 767 (S.D. W. Va. 1992)* (holding that debtor's officers and directors were entitled to administrative claim for indemnity or contribution for litigation costs pursuant to debtor's articles of incorporation because claim against officers and directors "related solely to postpetition conduct and services").

In their brief, the O&D Claimants state that each O&D Claimant timely filed a proof of claim stating that "the Claim is entitled to administrative priority status in accordance with *In re M. Frenville Co.*" (Doc. # 802 at 3-4) The O&D Claimants reliance on *Frenville* is misplaced. In *Frenville*, the Third Circuit held that an accounting firm's indemnification suit against the debtor, which arose as a result of a postpetition suit filed by defrauded [**17] security holders against the accountants but which implicated the accountants' prepetition conduct, constituted a postpetition claim because the accountants' "right to payment" arose only at the time the security holders' suit was filed. *Frenville,* *744 F.2d at 337*. Thus, the court simply held that the automatic stay provisions of § 362(a), which require that a stayed proceeding "was or could have been commenced" before filing, did not apply to the accountants' suit for indemnification. *Id. Frenville* did not involve an administrative expense claim.

More importantly, the *Frenville* court distinguished the third-party action at issue in that case from the example of a prepetition contingent claim in surety relationships. *Id. at 336-37*. The court reasoned that "when parties agree in advance that one party will indemnify the other party in the event of a certain occurrence, there exists a right to payment, albeit contingent, upon the signing of the agreement." *Id. at 336-37* (footnote omitted). In the case at bar, the O&D Claimants' indemnification rights are akin to a surety relationship created by MAWS's prepetition certificate of incorporation, under which the O&D [**18] Claimants are indemnified for certain prepetition conduct in the performance of their employment services. The only difference between the example given in *Frenville* and the certificate of incorporation at issue in the case at bar is the signing of an agreement. However, the corporation's commitment to indemnify, as provided in the certificate of incorporation, existed at the time each of the O&D Claimants' commenced employment, a fact of which the O&D Claimants were likely aware. The O&D Claimants now rely on its prepetition existence for their indemnification claims. In my view, the absence of a signed agreement is a technical nicety that makes no substantive difference between the prepetition surety agreement addressed in *Frenville* and the prepetition indemnity commitment in MAWS's certificate of incorporation.

The O&D Claimants argue that the certificate of incorporation is not a contract. To reach the conclusion that the certificate of incorporation created a contract on its effective date, the O&D Claimants argue, would produce the illogical result of granting the O&D Claimants a right to payment prior to their employment by MAWS.

In Delaware, a corporation's certificate [**19] of incorporation creates a contract between the state and the corporation. *See, e.g., Staar Surgical Co. v. Waggoner, 588 A.2d 1130, 1136 (Del. 1991)*. At a minimum, [*823] the O&D Claimants are third-party beneficiaries of that contract and those benefits come into existence as to each officer and director when each of them become an officer or director of MAWS. The O&D Claimants could hardly deny their status as third party beneficiaries given that their claim of indemnification rights is founded in that contract. Their relationship to MAWS is akin to the surety relationship which the *Frenville* court stated created a surety right prepetition.

In addition to the indemnification clause of the certificate of incorporation, the O&D Claimants assert that they are entitled to indemnification based on *§ 145(c)* of the Delaware General Corporations Law ("DGCL"), 8 *Del. C. § 145(c)*, which states that

> to the extent that a director, officer, employee, or agent of a corporation has been successful on the merits or otherwise in defense of any action, suit or proceeding referred to in subsections (a) and (b) of this section [which include the claims asserted in the Shareholder Litigation], [**20] or in defense of any claim, issue or matter therein, such person shall be indemnified against expenses (including attorneys' fees) actually and reasonably incurred by such person in connection therewith.

The mandatory indemnification requirement of *§ 145(c)* of the DGCL only springs into existence when the officer or director has been "successful on the merits or otherwise in defense" of the action. The "or otherwise in defense" language contemplates a negotiated settlement in which the suit is dismissed with prejudice and without any payment or assumption of liability by the officer or director. *See Wisener v. Air Express Int'l Corp., 583 F.2d 579 (2d Cir. 1978)*; *B & B Inv. Club v. Kleinert's, Inc., 472 F. Supp. 787 (E.D. Pa. 1979)*.

The O&D Claimants identify only one such case involving them that has been dismissed with prejudice pursuant to a stipulation of settlement under which the O&D Claimants made no payment to the plaintiffs. (Doc. # 802 at 4) However, MAWS asserts that all costs and fees incurred in connection with the Securities Litigation have been covered by MAWS's directors and officers insurance policy. (Doc. # 761 at 7-8) Because the O&D Claimants do [**21] not challenge this assertion, I conclude that the O&D Claimants have not yet incurred any actual or necessary expenses that would entitle them to indemnification under *§ 145(c)* of the DGCL.

The Claimants' Claims as Class 7 Subordinated Claims Pursuant to § 510(b)'s Subordination Provision

MAWS seeks to classify the Claimants' claims as Class 7 subordinated claims pursuant to *§ 510(b)*, which provides that

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

MAWS argues that Claimants' claims are for "reimbursement" within the contemplation of *§ 510(b)* and are therefore subordinated. NatWest and DLJ make two primary arguments against the application of *§ 510(b)* to [**22] their claims: (i) the language of *§ 510(b)* is ambiguous, and it does not encompass indemnification claims for liability and/or litigation expenses incurred by underwriters; and (ii) subordinating indemnification claims for litigation expenses of underwriters under *§ 510(b)* is in conflict with the legislative purpose of *§ 510(b)*. [3] The O&D Claimants [*824] do not address the *§ 510(b)* issue beyond stating that its administrative expense claims can not be subordinated under *§ 510(b)*. However, as stated above, I find that the O&D Claimants' claims are not allowable as administrative expense claims.

3 NatWest and DLJ appear to take differing stances on what parts of their claim to which *§ 510(b)* does not apply. NatWest argues that both its potential liability in the Securities Litigation, as well as its expenses incurred in that litigation, are not included within *§ 510(b)*'s scope, asserting that "*section 510(b)* was designed to subordinate the claims of owners of securities, not claims relating to liabilities and expenses incurred by an underwriter such as NatWest in connection with securities litigation." (Doc. # 805 at 6) Although DLJ fully adopts NatWest's position and asserts that "no part of DLJ's claim should be subordinated under *§ 510(b)*," (Doc. # 837 at 4) DLJ appears to argue only for excluding its attorneys' fees from *§ 510(b)*'s scope, conceding that, under *§ 510(b)*, "only claims for indemnification of liability are claims that are 'allowed . . . on account of' a 'damages' claim in the securities fraud action." (Doc. # 837 at 5)

[**23] To determine the meaning of *§ 510(b)*, I must first look to its language and determine if the language of the statute is ambiguous. *United States v. Ron Pair Enters., Inc., 489 U.S. 235, 242, 103 L. Ed. 2d 290, 109 S. Ct. 1026 (1989)*. If the language is unambiguous, the inquiry ends. *Id.* However, if the language is ambiguous, or if the literal application of the plain meaning "will produce a result demonstrably at odds with the intention of its drafters," then the intent of Congress needs to be examined in construing the statute's meaning. *Id.*

As discussed below, I find that the plain language of *§ 510(b)*, its legislative history, and applicable case law clearly show that *§ 510(b)* intends to subordinate the indemnification claims of officers, directors, and underwriters for both liability and expenses incurred in connection with the pursuit of claims for rescission or damages by purchasers or sellers of the debtor's securities. The meaning of amended *§ 510(b)*, specifically the language "for reimbursement or contribution . . . on account of [a claim arising from rescission or damages arising from the purchase or sale of a security]," can be discerned by a plain reading [**24] of its language.

Prior to its amendment in 1984, *§ 510(b)* provided that

> any claim for recission [sic] of a purchase or sale of a security of the debtor or of an affiliate or for damages arising from the purchase or sale of such a security shall be subordinated for purposes of distribution to all claims and interests that are senior or equal to the claim or interest represented by such security.

In 1984, Congress amended *§ 510(b)*, which now reads as follows:

> For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under *section 502* on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock. [4]

4 Comparison of the old and the new *§ 510(b)* is shown by the following--the added language underlined and deleted language in brackets:

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

[**25] NatWest correctly points out that Congress's 1984 amendment to *§ 510(b)* was not accompanied by any legislative history. NatWest argues that amended *§ 510(b)* is ambiguous and posits its view of the legislative history of the original version of the section to conclude that Congress could not have intended the result argued for by MAWS. In support of its position, NatWest repeatedly stresses its view of why the original *§ 510(b)* was enacted:

> The purpose of *section 510(b)* is to prevent *shareholders* from bootstrapping low priority equity interests into higher priority unsecured claims merely by claiming some sort of fraud in connection with the issuance of the securities.

(Doc. # 805 at 6)

> Congress enacted *section 510(b)* to prevent equity holders from subverting the [*825] absolute priority rule and being treated as general unsecured creditors . . . .

(Doc. # 805 at 7)

> The primary rationale for *section 510(b)* subordination is that shareholders buy into a particular, subordinate position and should not be able to elevate their claims by suing for recision [sic].

(Doc. # 805 at 10)

> It is abundantly clear that the purpose of *section 510(b)* is to [**26] prevent shareholders from being treated like creditors.

(Doc. # 805 at 12)

From this premise, Natwest argues that this purpose

> is in no way furthered by the subordination of liability and litigation expense claims of an underwriter such as NatWest. NatWest did not bargain for the shareholder suits nor for the expense it is required to incur to defend itself; it is not in the same position as the shareholders whose claims Congress intended to subordinate by virtue of *section 510(b)*. Accordingly, NatWest's claim should be treated just as all other general unsecured claims, and not subordinated as if it was a shareholder's claim.

(Doc. # 805 at 10-11)

NatWest's conclusion is premised on too narrow a focus of the purpose of *§ 510(b)*. Although it is correct that the principal focus of Congress in 1978 was to subordinate shareholder securities law claims, Congress's intent was not so limited. [5] In its original adoption, Congress did not limit the application of *§ 510(b)* to equity securities. *Section 510(b)* applies to claims arising from rescission or damages from the purchase or sale of a "security." The Bankruptcy Code defines the term "security" to include [**27] a "note," "bond," or "debenture." *§ 101(49)(A)(i), (iv), (v).* Thus, by its plain terms *§ 510(b)* is intended to apply to both debtholders and equityholders. *See Levine v. Resolution Trust Corp. (In re Coronet Capital Co.), 1995 U.S. Dist. LEXIS 10175, 1995 WL 429494*, *8 (S.D.N.Y. July 20, 1995) (citing *Kira v. Holiday Mart, Inc. (In re Holiday Mart, Inc.), 715 F.2d 430, 434 (9th Cir. 1983)*, for the proposition that *§ 510(b)* is "written in terms of 'any claim for rescission of a purchase or sale of a security' without distinction between equity securities and debt securities" and "commentators have construed the statute to apply to both."). [6] In the case before me, we have both Noteholder claims and shareholder claims.

5 Although the reported decisions and most of the literature on *§ 510(b)* speak in terms of securities law claims by purchasers and sellers, the claims contemplated by *§ 510(b)* can also be based on other case law and statutory law dealing with fraudulent conduct generally, breach of fiduciary duty and similar types of misconduct. For purpose of convenience, I will simply refer to all these claims as securities law claims--the type of claim we see most often in the *§ 510(b)* context.

[**28]

6 The legislative history makes clear that Congress made no mistake in using the Bankruptcy Code defined term "security:"

> The . . . subordination varies with the claim or interest involved. If the security is a debt instrument, the damages or rescission claim will be granted the status of a general unsecured claim. If the security is an equity security, the damages or rescission claim is subordinated to all creditors and treated the same as the equity security itself.

H.R. Rep No. 595, at 359 (1977); S. Rep. No. 989, at 74 (1978)

The legislative history of the original *§ 510(b)* reflects Congress's intent to include security holders' claims generally--both debtholder claims as well as shareholder claims. Discussing a 1973 law review article authored by Professors John J. Slain and Homer Kripke, Congress stated that

> [Professors Slain and Kripke] conclude that allocation of assets in a bankruptcy case is a zero-sum situation, and that rules of allocation in bankruptcy should be predictated on allocation of risk. The two risks to be considered are the risk of insolvency [**29] of the debtor and the risk of an unlawful issuance of securities. While both security holders and general creditors assume the risk of insolvency, Slain and Kripke conclude that the risk of illegality in securities issuance should be borne by those investing in securities and not by general creditors.

H.R. Rep. No. 595, at 195 (1977).

Thus, it is readily apparent that the rationale for *§ 510(b)* is not limited to preventing [*826] shareholder claimants from improving their position vis-a-vis general creditors; Congress also made the decision to subordinate based on risk allocation. Consequently, when Congress amended *§ 510(b)* to add reimbursement and contribution claims, it was not radically departing from an equityholder claimant treatment provision, as NatWest suggests; it simply added to the subordination treatment new classes of persons and entities involved with the securities transactions giving rise to the rescission and damage claims. The 1984 amendment to *§ 510(b)* is a logical extension of one of the rationales for the original section--because Congress intended the holders of securities law claims to be subordinated, why not also subordinate claims of other parties [**30] (e.g., officers and directors and underwriters) who play a role in the purchase and sale transactions which give rise to the securities law claims? As I view it, in 1984 Congress made a legislative judgment that claims emanating from tainted securities law transactions should not have the same priority as the claims of general creditors of the estate.

Adhering to its narrow understanding of the original purpose of *§ 510(b)*, NatWest argues that "broadening the scope of 510(b) to include claims of parties other than shareholders would signal a major expansion of the scope and purpose of *section 510(b)*." (Doc. # 805 at 11) It offers a "more likely" explanation:

> A more likely explanation is that Congress modified *section 510(b)* in furtherance of its original purpose: to prevent shareholders from bootstrapping a securities claim into a general unsecured claim. For example, if a shareholder had *some sort of* reimbursement or contribution claim as a result of the decrease in value of the shareholders' securities *that did not arise from the purchase or sale of a security*, such as a *contractual right* to indemnification independent of the purchase of the security, such shareholder [**31] could convert *its securities claim* into a general unsecured claim by pursuing its rights under the indemnification contract. In order to further the purpose of *section 510(b)*, the amendment *could have been designed* to guard against such bootstrapping by subordinating all securities-related claims of shareholders, regardless of the source of such claims. (Doc. # 805 at 11) (emphasis added)

I find this argument to be a speculative exercise and in conflict with the plain language of *§ 510(b)*. It is pure speculation to suggest that Congress had in mind "some sort of reimbursement or contribution claim as a result of the decrease in the value of the shareholders' securities." I have great difficulty in applying this concept to any type of shareholder/corporation transaction of which I am familiar. Indeed, I find a right of contribution to be an alien element in such a shareholder/corporation transaction. And because there is no 1984 amendment legislative history to aid in a search for meaning beyond the plain words of *§ 510(b)*, NatWest's argument cannot be seriously considered.

Furthermore, as I read it, the "some sort" of claim suggested by NatWest is not a securities [**32] law claim; it is a contract claim not within the scope of *§ 510(b)*. *Section 510(b)* covers claims that arise in connection with a purchase or sale of a security. NatWest's theoretical claim, as it states it in the above quote, "did not arise from the purchase or sale of a security."

The few reported decisions that address the issue before me support the conclusion that the Claimants' claims are subject to *§ 510(b)*'s subordination. NatWest and DLJ cite the Ninth Circuit's decision in *Christian Life Center Litig. Defense Comm. v. Silva (In re Christian Life Center), 821 F.2d 1370 (9th Cir. 1987)*, for the proposition that *§ 510(b)* does not require subordination of indemnity claims for the costs of defending security holder litigation, while MAWS counters that a later decision out of the Ninth Circuit, *Official Comm. Of Unsecured Creditors v. PaineWebber Inc. (In re De Laurentiis Entertainment Group), 124 B.R. 305, 308 (C.D. Cal. 1991)*, holds that *§ 510(b)* requires subordination of such litigation cost claims.

In *Christian Life*, a church raised funds for church construction by selling shares in a trust fund. *Christian Life, 821 F.2d at 1372*. A group of trust fund purchasers [**33] sued the [*827] church and its pastor for fraud and securities law violations after failing to recover their investment, and the church subsequently filed a bankruptcy petition. *Id.* The fraud claim against the pastor was tried and a jury found him not liable. *Id.* After trial, LDC, the group of attorneys representing the pastor and the other officers, submitted a claim against the estate for indemnity of the pastor's defense costs as a first priority administrative expense. *Id.* The bankruptcy court allowed the claim. *Id.* The creditors' committee and other creditors appealed. *Id.* The district court disallowed LDC's claim as an administrative expense and subordinated the indemnity claim to general creditors' claims. *Id.* LDC appealed. *Id.*

After deciding that LDC's claim was not allowable as an administrative expense, the *Christian Life* court took up the issue of whether the district court properly subordinated the claim pursuant to preamended *§ 510(b)*. 7 In so doing, the court looked to the purpose of *§ 510(b)*, which the court described as

> preventing equity stockholders or holders of other subordinated securities from converting their interests into [**34] higher priority general creditors' claims by asserting damages or rescission claims.

> Congress requires subordination of such claims because failure to subordinate the interests of shareholders to those of unsecured creditors would defeat the reasonable expectations of both. General creditors rely on the equity cushion created by the investment of shareholders and expect priority in bankruptcy. Shareholders in turn bargain for potential profit in exchange for expected subordination of their interests in bankruptcy. [8]

Id. at 1375 (citations omitted).

7 The court recognized Congress's 1984 amendment to *§ 510(b)*, which added, *inter alia*, the "reimbursement or contribution" language, *see supra*. The court stated that "we need not and do not determine whether amended *section 510(b)* requires subordination of indemnity claims." *Id. at 1375 n.6*.

8 I note that the *Christian Life* court, like NatWest, focuses on *§ 510(b)*'s purpose to prevent elevating shareholders into creditor positions. As discussed below, to some extent the *DeLaurentiis* court follows *Christian Life* in that regard. Although *§ 510(b)* obviously covers defrauded shareholders' claims, as noted above, its purpose is not so limited. Congress clearly intended that debenture purchasers (*i.e.*, creditors, not shareholders) having securities law claims also are to be subordinated to general unsecured creditors. Understanding this (as discussed in more detail above at pages 22-26), it seems to me, makes it easier to understand the 1984 amendment to *§ 510(b)* and why that amendment does not reflect a serious departure from its predecessor. Indeed, this may explain why Congress saw no need to make a legislative record in enacting the amendment.

[**35] The court then explored the committee's argument that those stated principles require the claim to be subordinated under *§ 510(b)*. The committee argued that if shareholders recovered damages from an officer of the debtor, and the officer in turn recovered by way of indemnity from the estate as an unsecured claimant, the shareholders would achieve indirectly what *§ 510(b)* prevents them from achieving directly, thus avoiding the subordination of their equity interests and defeating the expectations of unsecured creditors. *Id. at 1375-76*. The court rejected the committee's argument because the claims at issue in the case were for litigation costs, not for reimbursement for an officer's liability to security holders. *Id. at 1376*. The court stated that "security holders recover[] nothing from the officers when the latter are merely indemnified for defense costs." *Id.* The court then ended its discussion by concluding that *§ 510(b)* did not require subordination of indemnity claims for defense costs. *Id.*

In *De Laurentiis*, PaineWebber had entered into a series of underwriting agreements with the debtor, which included promises by the debtor that it would reimburse [**36] PaineWebber for litigation expenses incurred should it be sued in connection with the offerings. *De Laurentiis, 124 B.R. at 306*. PaineWebber was subsequently sued by securities holders on the theory that the prospectuses and SEC registration statements contained misstatements of fact. *Id. at 306-07*. PaineWebber claimed to have incurred over $ 800,000 in attorneys' fees in connection with defending itself in the suits, and asserted [*828] a contract-based claim for the litigation expenses against the debtor. *Id. at 307*. The debtor subsequently filed its plan of reorganization, which subordinated the PaineWebber litigation expense claims pursuant to *§ 510(b)*. *Id.* PaineWebber filed a motion to have its litigation expense claim classified as general unsecured claim, which the debtor and the creditors' committee opposed. *Id.* The bankruptcy court granted PaineWebber's motion and classified the claim as a general unsecured claim. *Id.* The committee and the debtor appealed. *Id.*

The *De Laurentiis* court first examined the language of *§ 510(b)*. The court, citing *United States v. Ron Pair Enters., Inc., 489 U.S. 235, 103 L. Ed. 2d 290, 109 S. Ct. 1026 (1989)*, stated [**37] that in interpreting *§ 510(b)*, it must first look at the language to determine if, on its face, it has plain meaning. *De Laurentiis, 124 B.R. at 307-08*. If so, then the court's inquiry should end unless "'the literal application of a statute will produce a result demonstrably at odds with the intention of its drafters.'" *Id. at 308* (quoting *Ron Pair, 489 U.S. at 242*). The court agreed with the committee's argument that PaineWebber's claim for litigation costs pursuant to its indemnification agreement was a claim for reimbursement under *§ 510(b)* because "reimbursement by definition includes indemnification." *Id.* The court rejected PaineWebber's argument that *§ 510(b)*'s language does not mandate subordination of litigation expense claims. PaineWebber stated that *§ 510(b)* did not mention litigation expense claims and, thus, the language must by interpreted by ascertaining congressional intent. *Id.* It asserted that the 1984 amendment language supported the litigation expense/liability claim distinction drawn in *Christian Life*. *Id.* PaineWebber focused on the words "on account of" in *§ 510(b)* as revealing Congress's intent to subordinate only those reimbursement [**38] or contribution claims which would be passed on to the equity holders asserting damage or rescission claims; if Congress had meant to include litigation expense claims, it would have used the words "associated with," "related to," or "arising out of" in the reimbursement clause. *Id.* Noting that Black's Law Dictionary defines "on account" to mean only "in part payment" or "in partial satisfaction," which did not have the limiting effect on which PaineWebber insisted, the court "declined to adopt the novel interpretation proposed by PaineWebber and interprets 'on account of' consistent with its meaning in normal usage." *124 B.R. at 308*. The court then found that the plain language of *§ 510(b)* included claims for indemnification of litigation expenses and, thus, the inquiry would continue only if PaineWebber could show "that subordination of an underwriter's claim for indemnification of attorneys' fees in this case is 'demonstrably at odds with the intention of its drafters' and not within the intended scope of *Section 510(b)*." *Id.* (quoting *Ron Pair, 489 U.S. at 242*).

The court found that PaineWebber, despite presenting "strong policy reasons to support [its] position," [**39] failed to meet its burden of showing that subordination of its claim would subvert congressional intent. *124 B.R. at 309-10*. The court then set forth three policy reasons supporting its plain reading conclusion.

The court noted that the fair allocation of risk between creditors and shareholders was an important policy consideration that the *Christian Life* court did not discuss. By allowing PaineWebber to recover as a general unsecured creditor, the court believed that it would be shifting the risks associated with the issuance of stock from the underwriter, who is in a better position to evaluate such risks, to the general unsecured creditors. *Id. at 310*. The legislative history discussed above clearly supports this position. See *supra pp. 22-26*.

The court listed two additional policy considerations supporting its conclusion. First, an attorneys' fees exception to *§ 510(b)* could potentially apply to all attorneys' fees claims in securities litigation, and not just those of the defendants. *Id.* Second, the court stated that failure to subordinate attorneys' fees claims may eliminate incentives to settle securities cases because indemnity claims against the debtor will [**40] be subordinated while litigation costs incurred in continuing to defend the lawsuit will be subsidized by the unsecured creditors. In articulating this last policy consideration, it is clear that the court [*829] saw no basis to debate the issue of the underwriter's liability claim being subject to *§ 510(b)*:

> Additionally, the failure to subordinate attorneys' fees may eliminate an incentive to settle securities cases. The Committee highlights the fact that underwriters are not permitted to pass on their damage claims that result from litigation surrounding the issued securities. *If PaineWebber settles the case by agreeing to pay some damages, its indemnity claim against the debtor is subordinated.* However, under PaineWebber's theory, if PaineWebber continues to litigate, its litigation costs are subsidized by the unsecured creditors. Thus, PaineWebber's interpretation of the statute could act as a disincentive to settlement.

Id. at 310. (emphasis added)

Following *DeLaurentiis*, the court in *In re Public Serv. Co., 129 B.R. 3, 5 (Bankr. D.N.H. 1991)* likewise found *§ 510(b)* unambiguous and the claimants' arguments for a differing interpretation wanting. The court [**41] found that officers' and directors' reimbursement claims, both as to damages and attorneys' fees, are to be subordinated under *§ 510(b)*. *Id. at 5*.

In summary, I conclude that *§ 510(b)* is unambiguous in requiring the subordination of Claimants' reimbursement claims, both for liability and expenses, resulting from securities law claims by purchasers or sellers of a debtor's securities. This conclusion is consistent with the legislative history and is supported by the reported decisions addressing the issue. NatWest's argument to the contrary about what Congress might have intended in 1984 is misconceived.

CONCLUSION

For the reasons set forth above, the O&D Claimants administrative expense priority claims are disallowed and the Claimants' claims are subordinated pursuant to *§ 510(b)* and therefore will be treated as Class 7 claims in MAWS's Plan.

Counsel for MAWS should submit an order on notice.

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In re JACOM COMPUTER SERVICES, INC. and UNICAPITAL CORPORATION, et al., Debtors.

Chapter 11, Case Nos. 00 B 42719 (CB) through 00 B 42837 (CB), (Jointly Administered)

UNITED STATES BANKRUPTCY COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

280 B.R. 570; *2002 Bankr. LEXIS 758*; *48 Collier Bankr. Cas. 2d (MB) 758*

July 23, 2002, Decided

SUBSEQUENT HISTORY: Subsequent appeal at *Cauff v. Jacom Computer Servs. (In re Jacom Computer Servs.), 2006 U.S. Dist. LEXIS 53868 (S.D.N.Y., July 31, 2006)*

DISPOSITION: [**1] Disbursing Agents' application to estimate claims number 295, 488 and 1132 at zero was granted.

COUNSEL: Cravath, Swaine & Moore, New York, New York, Evan R. Chesler, Esq., Daniel Slifkin, Esq., Of Counsel, for Morgan Stanley & Co., Inc., Salomon Smith Barney, and Friedman, Billings, Ramsey & Co.

Greenberg Traurig, New York, New York, Richard S. Miller, Esq., Robert T. Honeywell, Esq., Of Counsel, for Jacom Computer Services, Inc., UniCapital Corp., et al.

JUDGES: CORNELIUS BLACKSHEAR, UNITED STATES BANKRUPTCY JUDGE.

OPINION BY: CORNELIUS BLACKSHEAR

OPINION

[*571] **DECISION REGARDING CLAIMS OF UNDERWRITERS**

CORNELIUS BLACKSHEAR

UNITED STATES BANKRUPTCY JUDGE

In this confirmed chapter 11 case, the Disbursing Agent under the Plan, UniCapital Corporation, has moved to estimate certain disputed claims so that the Disbursing Agent may identify the universe of Class 5 General Unsecured Claims and establish an appropriate reserve. Claimants Morgan Stanley & Co., Inc., Cravath Swaine & Moore, and Friedman Billings Ramsey & Co., Inc., hereafter known as the Underwriters, have objected to the Debtor's application. Specifically, the Underwriters object to the Debtor's characterization of their claims [**2] as subordinated pursuant to *11 U.S.C. § 510(b)*. The Underwriters contend that their claim against the debtors is for indemnification of costs incurred by the Underwriters in connection with a class action lawsuit filed against the Underwriters and the debtors in connection with the initial public offering of the debtor's stock.

Section 510(b) deals with the subordination of claims arising from the purchase or sale of securities, rescission of such a purchase or sale, or "for reimbursement or contribution allowed under *section 502* on account of such a claim". The Debtors appear to argue that the Underwriters' claim is one "for reimbursement or contribution [*572] ...on account of" a claim arising from the purchase or sale of securities, and therefore must be subordinated pursuant to the plain language of the statute.

The Underwriters contend that claim arises from its contract with the debtor - the Underwriting Agreement dated May 14, 1998, annexed to the Proof of Claim of Salomon Smith Barney, Inc. This Court refers the parties to Section 7 "Indemnity and Contribution", where the debtors agreed to indemnify and hold harmless the Underwriters.

The issue presented by [**3] the Underwriters' motion appears to one of first impression in this Circuit. The parties have directed this Court to the few reported cases that discuss *section 510(b)*. One case, *In re Christian Life Center, 821 F.2d 1370*, written by the Ninth Circuit, unfortunately deals with *section 510(b)* BEFORE it was amended in 1984 to include, *inter alia*, the language "for reimbursement or contribution allowed under *section 502* on account of such a claim". The *Christian Life* case can therefore offer little if any guidance in interpreting the current statute.

Instead, this Court agrees with the analysis of *In re Mid-American Waste Systems, Inc.,* ***228 B.R. 816*****, written in 1999 by Chief Bankruptcy Judge Walsh in Delaware. In that case, Judge Walsh found that the indemnification claims of a debtor's underwriters for legal expenses incurred in defense of an action commenced by the debtor's shareholders, which action named the underwriters as defendants, for, among other things, securities fraud, should be subordinated pursuant to the plain language of** ***section 510(b).***

> *[Section] 510(b)* **intends to subordinate the indemnification claims of officers,** [**4] **directors, and underwriters for both liability and expenses incurred in connection with the pursuit of claims for rescission or damages by purchasers or sellers of the debtor's securities ... It is readily apparent that the rationale for** *section 510(b)* **is not limited to preventing shareholder claimants from improving their positions vis-a-vis general creditors; Congress also made the decision to subordinate based on risk allocation.**

In re Mid-American Waste Systems, Inc., ***228 B.R. 816, 824-6 (Bankr. Del. 1999).*** **The inclusion of reimbursement and contribution claims to those subordinated under** ***section 510(b)*** **is simply the addition of "new classes of persons and entities involved with the securities transactions giving rise to the rescission and damage claims."** *Id. at 826*. This Court agrees with Judge Walsh that the underwriters are in a better position to allocate risks associated with the issuance of securities and that it is inconsistent with the policies articulated in the legislative history of *section 510(b)* to force unsecured creditors to subsidize the underwriters' litigation costs. *See also In re Walnut Equipment Leasing Co., Inc., 1999 Bankr. LEXIS 1626, 1999 WL 1271762*, [**5] at *11 (Bankr. E.D. Pa. 1999); *In re De Laurentiis Entertainment Group, Inc., 124 B.R. 305, 310 (C.D. Cal. 1991)*.

Finally, taking the Underwriters argument that their claim arises from their indemnity contract with the Debtors, this Court notes that the indemnity provision is a provision of the Underwriting Contract. Further, this Court agrees with the analysis outlined in the *De Laurentiis* case: "reimbursement by definition includes indemnification, and indemnification naturally includes recovery of attorneys' fees." *124 B.R. at 308*. This Court is not persuaded by Underwriters' characterization of their claim as one for "indemnification" as opposed to "reimbursement" (the term used in the statute).

[*573] The Disbursing Agents' application to estimate claims number 295, 488 and 1132 at zero is granted. The attorneys for the Disbursing Agents are directed to settle an order on five business days' notice consistent with this decision.

Dated: New York, New York

July 23, 2002

/s/ Cornelius Blackshear

United States Bankruptcy Judge

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DEBTORS AND CREDITORS SHARING THE BURDEN:

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

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

Chair
The Honourable Richard H. Kroft

Deputy Chair
The Honourable David Tkachuk

November 2003

S. Subordination of Equity Claims

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

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

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

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

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

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

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

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

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

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DISCOVER SOMETHING GREAT

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

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Abstract

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

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

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.

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.

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

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

44. *SEC vs. WorldCom* 273 F. Supp. 2d 431 (S.D.N.Y. 2003).
45. The SEC commenced the civil action on 26 June 2002 in the U.S. District Court for the Southern District of New York against WorldCom alleging massive accounting fraud and WorldCom filed for Chapter 11 protection on 21 July 2002, given the size of the SEC's claims.
46. David Henry, "Subordinating Subordination: WorldCom and the Effect of *Sarbanes-Oxley's* Fair Funds Provision on Distributions in Bankruptcy" (2004) 21 Emory Bankruptcy Developments Journal 259 at 294.
47. *SEC vs. WorldCom* 273 F. Supp. 2d 431 (S.D.N.Y. 2003) at 435. The settlement amount was 75 times greater than any prior penalty for accounting fraud.
48. *Ibid.*
49. *Ibid.*

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

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

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

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

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

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

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

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

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

54. *Ibid.* at 169.

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

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

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

C. The treatment of equity claims in Canada

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

74. *Re Blue Range Resource Corp.*, 2000 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.

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.

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.

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

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

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

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

117. *Ibid.* at 159.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

127. Bill C-62, *ibid.*, proposed s. 54.1, *BIA* and s. 22.1, *CCAA*.

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

129. Bill C-62, *supra*, note 115, proposed s. 19(2), *CCAA*.

130. Bill C-62, *ibid.*, proposed s. 69.6, *BIA* and proposed s. 11.1 (1), *CCAA*.

131. Bill C-62, *ibid.*, proposed s. 11.1, *CCAA* and s. 69.6, *BIA*.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

139. *Ibid.*

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

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

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

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

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

141. *Ibid.*

142. *Ibid.*

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

157. *Ibid.* at 2.

158. *Ibid.*

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

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

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

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

F. Subordination of stock-based compensation claims

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

168. An example would be early discussions regarding merger.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

190. Ibid.

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

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

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

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

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

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

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

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

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

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

198. Section 137, *BIA*.

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

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

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

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

203. *Ibid.* at para. 3.

204. Section 264, *BIA*.

205. Section 265, *BIA*.

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

Hence, the legislation recognizes that securities firms hold the capital of customers and that they are entitled to return of their money to that extent on a *pro rata* basis before unsecured creditors.

The cases under Canadian law highlight the tension between creditors and securities holders in bankruptcy, although for the most part, the statutory provisions appear to have streamlined and clarified how assets are to be dealt with. In particular, the first cases have been primarily disputes with respect to the composition of the customer pool, because making assets available to securities holders means they are not available to meet creditors' claims.

In *Re Vantage Securities Inc.*, a bankrupt securities firm held certain monies in trust for the plaintiff pursuant to a contractual arrangement unrelated to its securities business.[207] The plaintiff sought to exclude the property based on trust provisions under the *BIA* that specify that trust property held by a bankrupt does not form part of the bankrupt's assets. The trustee in bankruptcy denied the claim on the basis that cash under Part XII meant all cash, including trust cash and that pursuant to s. 255 of the *BIA*, which specifies that where provisions in Part XII are in conflict with any other provision of the *Act*, they take precedence.[208] The British Columbia Supreme Court, in affirming the trustee's decision, held that on the plain reading of the statute, the section did not exclude trust property. The Court held that by enacting Part XII, Parliament's objective was to simplify the resolution of trust claims from customers of securities firms and to simplify securities firm bankruptcies by eliminating the myriad of competing trust claims and the associated legal costs and time delays.[209] It held that the amendments were aimed at removing the entire concept of trust law for securities except where those securities are customer named securities and cash when the bankrupt company was a securities firm.[210] The Court held that pursuant to s. 261 (1), all cash vested in the trustee, not just cash beneficially owned by the firm.[211]

In another Canadian judgment, *Re Marchment & Mackay Ltd.*, a bankrupt stockbroker firm, after lengthy litigation with securities authorities, had its license revoked and subsequently made an assignment in bankruptcy.[212] Section 262 of the *BIA* exposes the customer pool funds to the costs of administration of the estate in bankruptcy, given that securities other than customer name securities vest in the trustee. The maximum amount that can be paid out to a customer of a bankrupt for 'direct out

206. Section 266, *BIA*.

207. *Re Vantage Securities Inc.* (1998) 64 B.C.L.R. (3d) 148; 9 C.B.R. (4th) 169 (B.C. S.C. [In Chambers]).

208. Section 255, *BIA* specifies: 'All the provisions of this Act, in so far as they are applicable, apply in respect of bankruptcies under this Part, but if a conflict arises between the application of the provisions of this Part and the other provisions of this Act, the provisions of this Part prevail'.

209. *Ibid.* at para. 10.

210. *Ibid.* at para. 12. The Court held that for all other real or personal property held by a bankrupt securities firm, trust principles continued to apply.

211. *Ibid.* at para. 13.

212. *Re Marchment & Mackay Ltd.* (2000), 16 C.B.R. (4th) 247 (Ont. S.C.J. [Commercial List]).

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of pocket losses' under the requisite trust plan is Cdn $5000.[213] The Court was satisfied that this amount was Cdn $5000 and not Cdn $5000 less amounts that may be recovered otherwise than out of the trust plan.[214] The Court held that the plan should be given a purposeful, fair, and liberal interpretation, observing the unique nature of the customers' loss in that the securities and cash were rightly assets to which they would be unquestionably entitled to but for the assets vesting in the trustee under Part XII. The Court held that by filing a voluntary assignment in bankruptcy, the bankrupt brokerage firm put securities that had been ordered and not delivered beyond the bankrupt's ability to follow further customer directions as such securities vested in the trustee.

In *Ashley v. Marlow Group Private Portfolio Management Inc.*, the Marlow group of companies had operated as securities and investment dealers and investment advisers.[215] It was placed into receivership when more than Cdn $3 million disappeared from clients' trust accounts and its operations were suspended by the Ontario Securities Commission. The receiver was to identify and secure the assets, quantify the losses and determine the distribution of the remaining funds. A number of issues arose in the case, including, whether securities were being held in trust and thus should be returned to investors; whether Marlow Group's situation should be administered through a bankruptcy proceeding; and whether Marlow Group was in fact a securities firm within the meaning of Part XII of the *BIA*, because buying and selling securities was allegedly not Marlow Group's primary business activity, rather investment advice was. The receiver sought direction on placing the assets into the customer pool.[216]

The Ontario Superior Court of Justice considered the issue of what is a securities firm. In Canada, French, and English versions of the statutory language have equal authority, and here, the definition of securities firm did not completely align in its language. In comparing the French and English versions of the statutory provision, the Court found that the English version contained the phrase 'carries on the business', suggestive of being one's primary business, whereas the French version was silent on this language.[217] The Court held that a reasonable interpretation of the definition was that it included a corporation that buys and sells securities as part of its business, not that it had to be its primary business.[218] Thus, the broad definition

213. The Ontario Securities Commission requires as a condition of brokerage registration that securities firms enter into a trust agreement for the general purpose of protection of customers of securities firms, *ibid.* at para. 3.

214. *Ibid.* at para. 4. The Court observed that the thrust of the limitation is to avoid a double recovery for a specific item of loss; here, recovery from Marchment's estate in bankruptcy of other items was not a double recovery.

215. *Ashley vs. Marlow Group Private Portfolio Management Inc.*, 2006 CarswellOnt 3449 (2006) O.J. No. 1195, 19 C.B.R. (5th) 17 (Ont. S.C.J. [Commercial List]).

216. Some of the securities claimants sought the return of their securities to avoid inclusion in the pool, in order that they would receive 95% of the value of their claims, compared with 60% of value if included in the customer pool.

217. Section 253, *BIA*.

218. Relying on section 18 of the Canadian *Charter of Rights and Freedoms*, the Court held that both versions were equally authoritative that the French version formed part of the context in which the English version needed to be interpreted, and the court's role is to find a common interpretation. The Court held that the reference to 'including any person required to be registered' meant that the definition was not limited to such persons.

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of 'securities firm' was determined to be unambiguous, and a corporation that buys and sells securities as part of its business falls under the definition of securities firm and is subject to the application of Part XII.[219] The Court also held that since the provisions applied equally to cash and securities, accordingly,'all securities held by the securities firm at the date of bankruptcy vest in the trustee, not just the securities owned beneficially by the firm'.[220] The only exclusion from the pool is the customer name securities. Section 255 specifies that to the extent that Part XII conflicts with other provisions of the *BIA*, Part XII prevails; and since cash and securities held in trust for the benefit of customers vest in the trustee, then Part XII prevails over the *BIA* trust provisions and trust claims are prohibited.[221] The Court also dismissed the receiver's motion for substantive consolidation based on concern about the lack of evidence of the effect on all creditors if there was substantive consolidation; however it held that the estates were to be procedurally consolidated and administered together.[222]

Another issue in *Ashley v. Marlow Group Private Portfolio Management* was whether units in a limited partnership could be re-registered in the claimants' names before assignment into bankruptcy in order to qualify them as customer name securities holders.[223] The Court determined that the corporate defendant held the units in trust for the claimants, which placed them in the same position as the other securities that were not customer name securities, and as they were not the subscribers, the Court concluded that there was no basis to require the register to be altered. Thus, all of the disputed assets were found to be part of the customer pool fund.[224]

In *Re White*, the claimant sought a declaration that it was the beneficiary of a constructive trust, as its money had flowed through a third party to the bankrupt.[225] It sought recovery of trust monies from the estate of the bankrupt. The Registrar observed that for purpose of the application, the bankrupt was likely involved in a ponzi scheme that collapsed shortly after the money had been transferred.[226] The Registrar held that while the transaction in question involved a security, there was no evidence that the defendant, though registered to sell securities, was carrying on business as a securities firm, and thus the definition of securities firm was not met and Part XII was not applicable. The Registrar also found that the situation did not warrant the imposition of a constructive trust or finding of unjust enrichment as there was not sufficient evidence of wrongful conduct to engage the court's conscience and in the circumstances, it was not appropriate to alter the *BIA* scheme of distribution.[227]

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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)(1-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]

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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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 Nos. C56115, C56118, C56125
Court File No. CV-12-9667-00CL

COURT OF APPEAL FOR ONTARIO

Proceeding commenced at Toronto

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VOLUME 2 OF 2

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