

**ONTARIO
SUPERIOR COURT OF JUSTICE
COMMERCIAL LIST**

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

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

**BRIEF OF AUTHORITIES
(motion for an Equity Claims Order,
returnable on June 26, 2012)**

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1. L. Abrams and K.P. McGuiness, *Canadian Civil Procedure Law*, 2nd ed. (Toronto: LexisNexis, 2010)
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3. Standing Senate Committee on Banking Trade and Commerce, *Debtors and Creditors Sharing the Burden*, 2003
4. *Re Nelson Financial Group Ltd.* (2010), 71 C.B.R. (5th) 153 (Ont. S.C.J.)
5. *Re Central Capital Corp.* (1995), 29 C.B.R. (3d) 33 (Ont. C.J. (Gen. Div. – Commercial List))
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7. *National Bank of Canada v. Merit Energy Ltd.* (2001), 28 C.B.R. (4th) 228 (Alta. Q.B.)
8. *Re EarthFirst Canada Inc.* (2009), 56 C.B.R. (5th) 102 (Alta. Q.B.)
9. *Return on Innovation Capital Ltd. v. Gandi Innovations Ltd.* (2011), 83 C.B.R. (5th) 123 (Ont. S.C.J.)

TAB 1

CANADIAN
CIVIL PROCEDURE LAW

Second Edition

Linda S. Abrams

Kevin P. McGuinness



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- (i) wilfully conceals from the person with the claim the fact that injury, loss or damage has occurred, that it was caused by or contributed to by an act or omission or that the act or omission was that of the person against whom the claim is made, or
- (ii) wilfully misleads the person with the claim as to the appropriateness of a proceeding as a means of remedying the injury, loss or damage.

(b) Live Dispute (Moot Cases)

§3.36 The common law recognizes no such thing as a gap in the law. Either a party has a cause of action or other claim, or he or she does not; if a claim is not made out, then the defender is entitled to judgment. In addition, once a right exists, it is presumed to be enforceable.⁹¹ Courts in common law jurisdictions will generally only hear a case involving an actual dispute between parties. Although it is possible by statute for either the federal or provincial government to direct a reference to the courts in relation to a hypothetical dispute, no such procedure was available at common law where a party wished to seek the guidance of a court with respect to the law.⁹² Neither is there any procedure for a private citizen to obtain a court ruling on a hypothetical point of law. Furthermore, once a dispute has for some reason ceased to be operative or to apply, the subject matter of the dispute is generally considered “moot”, and accordingly the courts will not in the ordinary case proceed to hear it.⁹³ However, in *Borowski v. Canada (Attorney General)*, the Supreme Court made clear that, while moot proceedings are not encouraged, the court may consider such matters where a fit case is made out for doing so.⁹⁴ The court said:

The doctrine of mootness is an aspect of a general policy or practice that a court may decline to decide a case which raises merely a hypothetical or abstract question. The general principle applies when the decision of the court will not have the effect of resolving some controversy which affects or may affect the rights of the parties. If the decision of the court will have no practical effect on such rights, the

⁹¹ *Board v. Board*, [1919] A.C. 956 at 962-63, [1919] 2 W.W.R. 940 (P.C.), *per* Viscount Haldane:

Their Lordships are of opinion that, in the absence of any explicit and valid legislative declaration that the Court was not to exercise jurisdiction in divorce, that Court was bound to entertain and to give effect to proceedings for making that right operative. Had the Legislature of the Province enacted that its tribunals were not to give effect to the right which the Dominion Parliament had conferred in the exercise of its exclusive jurisdiction, a serious question would have arisen as to whether such an enactment was valid. But not only is there no such enactment but, on the mere question of construction of the language of the Provincial Act of 1907, their Lordships are of opinion that a well-known Rule makes it plain that the language there used ought to be interpreted as not excluding the jurisdiction. If the right exists, the presumption is that there is a Court which can enforce it, for if no other mode of enforcing it is prescribed, that alone is sufficient to give jurisdiction to the King's Courts of justice. In order to oust jurisdiction, it is necessary, in the absence of a special law excluding it altogether, to plead that jurisdiction exists in some other Court.

⁹² In some cases, *e.g.*, under the *Trustee Act*, R.S.O. 1990, c. T.23, there is a specific authority to seek directions from the court.

⁹³ *Ontario v. Clark*, [1944] S.C.J. No. 50, [1944] S.C.R. 69 at 72 (S.C.C.), *per* Duff C.J.

⁹⁴ [1989] S.C.J. No. 14, [1989] 1 S.C.R. 342 (S.C.C.).

court will decline to decide the case. This essential ingredient must be present not only when the action or proceeding is commenced but at the time when the court is called upon to reach a decision. Accordingly if, subsequent to the initiation of the action or proceeding, events occur which affect the relationship of the parties so that no present live controversy exists which affects the rights of the parties, the case is said to be moot. The general policy or practice is enforced in moot cases unless the court exercises its discretion to depart from its policy or practice. The relevant factors relating to the exercise of the court's discretion are discussed hereinafter.

The approach in recent cases involves a two-step analysis. First it is necessary to determine whether the required tangible and concrete dispute has disappeared and the issues have become academic. Second, if the response to the first question is affirmative, it is necessary to decide if the court should exercise its discretion to hear the case. The cases do not always make it clear whether the term "moot" applies to cases that do not present a concrete controversy or whether the term applies only to such of those cases as the court declines to hear. In the interest of clarity, I consider that a case is moot if it fails to meet the "live controversy" test. A court may nonetheless elect to address a moot issue if the circumstances warrant.⁹⁵

In *R. v. Smith*,⁹⁶ a man appealed his murder conviction. He died before the appeal was heard. The Newfoundland and Labrador Court of Appeal abated the appeal. The Supreme Court of Canada held that the appeal was rendered moot by the appellant's death, but that the Court had a discretion to proceed with a moot appeal. Binnie J. commented that this discretion should be exercised only in exceptional circumstances, such as:

... where the death of the appellant is survived by a continuing controversy which, notwithstanding the death of the individual most directly affected by the appeal, requires resolution in the interests of justice.⁹⁷

§3.37 A moot case is not to be confused with a test case, although both types of proceedings might lend themselves towards adjudication on specific cases that have yet to arise. The term "test case" ordinarily refers to a proceeding that will determine the issues that will arise in other cases that are pending or, at least, contemplated.⁹⁸

(c) Proceedings that May Be Instituted Only with Leave

§3.38 Certain types of proceedings may be instituted only with leave of the court. Derivative actions under the Ontario *Business Corporations Act* — and corresponding legislation in force across the country — fall within this class of proceedings. The case law with respect to the granting of such leave is highly instructive as to the types of considerations that the court should take into account when presented with a motion for leave. It has been held that the court is not required to determine that the institution of the derivative action will be in

⁹⁵ [1989] S.C.J. No. 14, [1989] 1 S.C.R. 342 at paras. 15-16 (S.C.C.), *per* Sopinka J.

⁹⁶ [2004] S.C.J. No. 11, [2004] 1 S.C.R. 385 (S.C.C.).

⁹⁷ [2004] S.C.J. No. 11, [2004] 1 S.C.R. 385 at para. 4 (S.C.C.).

⁹⁸ *Vemell v. Barnardo's*, [2004] O.J. No. 4171, 73 O.R. (3d) 13 at para. 25 (Ont. S.C.J.), *per* Cullity J.

TAB 2

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



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

Rizzo & Rizzo Shoes Ltd., Re

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

Supreme Court of Canada

Gonthier, Cory, McLachlin, Iacobucci, Major JJ.

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

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

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

Raymond M. Slattery, for the respondent.

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

Subject: Labour and Employment; Insolvency

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

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

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

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

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

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

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

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

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

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

Held: The appeal was allowed.

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

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

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

Arrêt: Le pourvoi a été accueilli.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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Statutes considered / Législation citée:

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

Generally — referred to

s. 121(1) — considered

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

s. 13 — referred to

s. 13(2) — considered

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

s. 40(7) — considered

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

Generally — referred to

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

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

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

s. 40(2) — referred to

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

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

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

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

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

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

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

s. 2(1) — considered

s. 2(3) — considered

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

s. 10 — considered

Interpretation Act/Interprétation, Loi d', R.S.O./L.R.O. 1990, c. 1.11

s. 10 — considered

s. 17 — considered

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

s. 74(1) — considered

s. 75(1) — considered

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APPEAL by employees of bankrupt employer from decision reported at (1995), 30 C.B.R. (3d) 1, 9 C.C.E.L. (2d) 264, 22 O.R. (3d) 385, (sub nom. *Ontario Ministry of Labour v. Rizzo & Rizzo Shoes Ltd.*) 95 C.L.L.C. 210-020, (sub nom. *Re Rizzo & Rizzo Shoes Ltd. (Bankrupt)*) 80 O.A.C. 201 (C.A.), reversing decision reported at (1991), 11 C.B.R. (3d) 246, 6 O.R. (3d) 441, 92 C.L.L.C. 14,013 (Gen. Div.), reversing disallowance of claim by trustee in bankruptcy.

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

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

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

1. Facts

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

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

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

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

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2. Relevant Statutory Provisions

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

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

7.--

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

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

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

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

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

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

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

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

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

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

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

and such notice has expired.

.....

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

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

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

.....

40a ...

(1a) Where,

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

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

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

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

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

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

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

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

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

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

.....

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

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

3. Judicial History

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

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

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

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

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

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

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

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

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

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

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

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

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

4. Issues

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

5. Analysis

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

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

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

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

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

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

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

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

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

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

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

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

need to protect employees. Section 40 of the *ESA* requires employers to give their employees reasonable notice of termination based upon length of service. One of the primary purposes of this notice period is to provide employees with an opportunity to take preparatory measures and seek alternative employment. It follows that s. 40(7)(a), which provides for termination pay in lieu of notice when an employer has failed to give the required statutory notice, is intended to "cushion" employees against the adverse effects of economic dislocation likely to follow from the absence of an opportunity to search for alternative employment. (Innis Christie, Geoffrey England and Brent Cotter, *Employment Law in Canada* (2nd ed. 1993), at pp. 572-81.

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

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

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

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

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

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

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

2. ...

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

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

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

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

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

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

The circumstances surrounding a closure will govern the applicability of the severance pay legislation in some defined situations. For example, a bankrupt or insolvent firm will still be required to pay severance pay to employees to the extent that assets are available to satisfy their claims.

.....

...the proposed severance pay measures will, as I indicated earlier, be retroactive to January 1 of this year. That retroactive provision, however, will not apply in those cases of bankruptcy and insolvency where the assets have already been distributed or where an agreement on a proposal to creditors has already been reached. [Ontario, Legislative Assembly, *Debates*, No. 36, at pp. 1236-37 (June 4, 1981)]

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

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

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

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

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

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

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

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

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

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

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

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

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

6. Disposition and Costs

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

Appeal allowed.

Pourvoi accueilli.

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TAB 3



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

Canadian insolvency law does not subordinate shareholder or equity damage 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. 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 of shares, and damages (including securities fraud claims) are to be treated as equity claims subordinate to all other secured and unsecured claims against the debtor” 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:

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.

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

TAB 4

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



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

Nelson Financial Group Ltd., Re

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

Ontario Superior Court of Justice [Commercial List]

Pepall J.

Judgment: November 16, 2010

Docket: 10-8630-00CL

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

J.H. Grout, S. Aggarwal for Monitor

Pamela Foy for Ontario Securities Commission

Frank Lamie for Nelson Financial Group Ltd.

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

Michael Beardsley, Respondent for himself

Clifford Holland, Respondent for himself

Arnold Bolliger, Respondent for himself

John McVey, Respondent for himself

Joan Frederick, Respondent for herself

Rakesh Sharma, Respondent for himself

Larry Debono, Respondent for himself

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

Keith McClear, Respondent for himself

Subject: Corporate and Commercial; Insolvency

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

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

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

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

Cases considered by *Pepall J.*:

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

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

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

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

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

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

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

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

Statutes considered:

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

s. 2 — considered

s. 2 "creditor" — considered

s. 121(1) — considered

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

Generally — referred to

s. 23(3) — referred to

s. 248 — referred to

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

Generally — referred to

s. 2 — referred to

s. 2(1) "claim" — considered

s. 2(1) "equity claim" — considered

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

s. 6(8) — considered

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

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

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

Generally — referred to

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

Pepall J.:

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

Background Facts

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

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

(a) Noteholders

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

(b) Preferred Shareholders

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

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

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

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

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

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

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

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

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

(c) Insolvency

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

(d) Ontario Securities Commission

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

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

(e) Legal Opinion

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

(f) Development of Plan

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

Motion

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

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

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

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

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

20 In brief, Mr. Styles submits that:

(a) the investment transactions were void because there was no prospectus contrary to the provisions of the *Securities Act* and the Styles were not accredited investors; the preferred shares were issued contrary to section 23(3) of the *OBCA* in that Nelson was insolvent at the relevant time and as such, the issuance was a nullity; and the conduct of the company and its principal was oppressive contrary to section 248 of the *OBCA*; and that

(b) the Styles' claim is in respect of an undisputed agreement relating to the conversion of their promissory notes into preferred shares which agreement is enforceable separate and apart from any claim relating to the preferred shares.

The Issue

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

The Law

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

Section 2 of the *CCAA* states:

In this Act,

"Claim" means any indebtedness, liability or obligation of any kind that would be a claim provable within the meaning of section 2 of the *Bankruptcy and Insolvency Act*;

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

(a) a dividend or similar payment,

(b) a return of capital,

(c) a redemption or retraction obligation,

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

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

"Equity Interest" means

(a) in the case of a corporation other than an income trust, a share in the corporation — or a warrant or option

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

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

Section 6(8) states:

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

Section 22.1 states:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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- (a) declared but unpaid dividends;
- (b) unperformed requests for redemption;
- (c) compensatory damages for the loss resulting in the purchased preferred shares now being worthless and claimed to have been caused by the negligent or fraudulent misrepresentation of Nelson or of persons for whom Nelson is legally responsible; and
- (d) payment of the amounts due upon the rescission or annulment of the purchase or subscription for preferred shares.

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

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

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

Motion granted.

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

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

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

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

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

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

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FN7 Supra, note 2.

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

FN9 Supra, note 5.

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

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TAB 5

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1995 CarswellOnt 31, 29 C.B.R. (3d) 33, 22 B.L.R. (2d) 210

Central Capital Corp., Re

Re CENTRAL CAPITAL CORPORATION; Re Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, as amended

Re appeal from disallowance of claims of JAMES W. McCUTCHEON, CENTRAL GUARANTY TRUST COMPANY (as trustee for registered retirement savings plan of JAMES W. McCUTCHEON) and CONSOLIDATED S.Y.H. CORPORATION by PEAT MARWICK THORNE INC. (administrator of certain assets of CENTRAL CAPITAL CORPORATION)

Ontario Court of Justice (General Division — Commercial List)

Feldman J.

Judgment: January 9, 1995[FN*]

Docket: Doc. B28/93

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Counsel: *Bryan Finlay, Q.C.*, and *Jim Buhlman*, for James McCutcheon and Central Guaranty Trust Company.

James Grout and *Aida Van Wees*, for Consolidated S.Y.H. Corporation.

T.J. O'Sullivan and *P.G. Macdonald*, for unsecured creditors of Central Capital Corporation.

N. Saxe, for Peat Marwick Thorne Inc.

G. Rubenstein, for Central Capital Corporation (excused at opening of motion).

Subject: Corporate and Commercial; Insolvency

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

Corporations --- Arrangements and compromises — Under Companies' Creditors Arrangement Act — Arrangements — Effect of arrangement — General.

Corporations — Arrangements and compromises — Companies' Creditors Arrangement Act — Claims — Preferred shares having right of retraction — Company unable to redeem shares because of insolvency — Preferred shareholders claiming that right constituted debt and claim provable — Administrator denying claims and decision upheld on appeal — Preferred shareholders having no claim under plan of arrangement — Companies' Creditors Arrange-

1995 CarswellOnt 31, 29 C.B.R. (3d) 33, 22 B.L.R. (2d) 210

ment Act, R.S.C. 1985, c. C-36.

An order was made declaring that the *Companies' Creditors Arrangement Act* ("CCAA") applied to CCC and staying all proceedings against CCC. Under the reorganization, the most valuable assets of CCC were transferred to a new company. CCC's creditors were entitled to receive shares and debentures in the new company to reflect some of their outstanding debt. The balance of the debt and equity claimants, including the shareholders of CCC, received common shares in CCC, which now lacked its most valuable assets.

Some of the preferred shares had a right of retraction attached to them; that is, the shareholders had a right to require the company to redeem the shares at a fixed price and on a certain date; the company was then obliged to redeem, provided it met certain legislated solvency tests at that date. The appellants held those shares and argued that the retraction right constituted a future contingent liability of CCC and was, therefore, a debt provable in bankruptcy. Even though CCC was prohibited from making payment to redeem the shares because of insolvency, it was not relieved of its obligation to redeem. The administrator denied their claims and the preferred shareholders appealed.

Held:

The appeals were dismissed.

Since the preferred shares remained as shares until they were redeemed, the preferred shareholders were not creditors and had no claims provable. Under the right of retraction, CCC's obligation to pay all or part of the redemption price for deposited shares was contingent on compliance with applicable law, which in this case meant the solvency tests set out in the *Canada Business Corporations Act*. Since no payment could be made until the tests were met, until then, there was no present obligation to pay. CCC was obligated to retain the shares and redeem them if and when the tests were met. Until that time, there was no debt that could be enforced by court action that would result in a money judgment. The right of retraction also could not be considered a contingent claim. Until the shares were actually redeemed by payment, they remained outstanding shares.

The case turned on whether the right of retraction itself created a debt on the date the company became obligated to redeem, even if the company could not actually redeem by payment on that date, or a contingent future debt, and not on whether the preferred shares themselves with the right of retraction were actually debt documents. Even though a right of retraction at the option of the preferred shareholder is less common than the usual right of the company to redeem at its option, that right is one of the incidents or provisions attaching to the preferred shares; it does not, however, change the nature of those shares from equity to debt.

Cases considered:

Canada Deposit Insurance Corp. v. Canadian Commercial Bank, [1992] 3 S.C.R. 558, 16 C.B.R. (3d) 14, 5 Alta. L.R. (3d) 193, 97 D.L.R. (4th) 385, 7 B.L.R. (2d) 113, (sub nom. *Canada Deposit Insurance Corp. v. Canadian Commercial Bank (No. 2)*) 143 N.R. 321, 131 A.R. 321, 25 W.A.C. 321 — *considered*

East Chilliwack Agricultural Co-operative, Re (1989), 74 C.B.R. (N.S.) 1, 42 B.L.R. 236, 58 D.L.R. (4th) 11 (B.C. C.A.), reversing (1988), 70 C.B.R. (N.S.) 52, 39 B.L.R. 20 (B.C. S.C.) — *distinguished*

Olympia & York Developments Ltd., Re (1993), (sub nom. *Olympia & York Developments Ltd. v. Royal Trust Co.*) 18 C.B.R. (3d) 176, 102 D.L.R. (4th) 149 (Ont. Gen. Div.) — *referred to*

Statutes considered:

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Bankruptcy Act, R.S.C. 1985, c. B-3 —

s. 121

Canada Business Corporations Act, R.S.C. 1985, c. C-44 —

s. 34

s. 35

s. 36

s. 40

s. 40(3)

s. 42

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

Cooperative Association Act, R.S.B.C. 1979, c. 66 —

s. 15

Appeals from denial of claims by administrator under *Companies' Creditors Arrangement Act* plan of reorganization.

Feldman J.:

1 As part of a plan of arrangement of Central Capital Corporation under the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36, as amended, the most valuable assets of the company were transferred to a Newco, and creditors of Central Capital were entitled to receive shares and debentures in Newco to reflect the quantity of their outstanding debt. Under the plan, the balance of the debt and equity claimants including shareholders of Central Capital received common shares in Central Capital, now minus the most valuable assets.

2 The appellants in this matter were holders of millions of dollars worth of preferred shares of Central Capital, which shares had attached to them a right of retraction, meaning a right to require the company to redeem the shares at a fixed price and on a certain date, which the company is obliged to do essentially as long as it meets certain legislated solvency tests at that date. The appellants made a claim to the administrator to participate in Newco on the basis that their preference shares with the retraction right constituted a debt owed by the company, and they are therefore creditors entitled to claim and participate in Newco. The administrator denied the claims, leaving them as common shareholders of Central Capital.

3 On this motion, the issue is whether the appellants were creditors of Central Capital on June 15, 1992, the effective date, and therefore entitled to participate with other creditors in Newco.

Facts

4 The facts for the purpose of this motion are set out in an agreed statement of facts.

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5 Mr. McCutcheon and his R.R.S.P. received Series "B" Senior Preferred Shares of Central Capital as part of the consideration for the sale to the company of Class "B" Voting Shares of Canadian General Securities Limited in 1987. The sale price for 161,000 shares of Canadian General Securities Limited was \$400 per share, plus for each share, 7 Series "B" Senior Preferred Shares of Central Capital, or if they could not be authorized in time, an additional \$175 per share. When Mr. McCutcheon deposited his Series B Senior Preferred Shares for retraction on July 1, 1992, the redemption amount including the redemption price of \$25 per share plus accrued dividends from July 1, 1991 was \$10,913,593.69. The redemption amount for the shares in his R.R.S.P. was \$697,526.68.

6 Consolidated S.Y.H. Corporation (formerly Scottish and York Holdings Limited) sold to Central Capital the shares of Central Canada Insurance Services Limited, Eaton Insurance Company, Scottish & York Insurance Co. Limited and Victoria Insurance Company of Canada in consideration of the issuance of 60,116,000 Junior Preferred Series A Shares and 9,618,560 Junior Preferred Series B Shares. In its proof of claim submitted to the administrator, Consolidated S.Y.H. claimed the amount of \$72,388,836 as the amount that would be owing to it on the date of retraction of its shares.

7 The provisions attaching to the Series B Senior Preferred Shares are contained in a certificate of amendment of the articles of the company, and include a preferred dividend and a right of retraction. The retraction right for the Series "B" Senior Preferred Shares is set out in art. 4 of the Provisions of those shares as follows:

Retraction Privilege

4.1 Retraction of Series B Senior Preferred Shares

Each holder of Series B Senior Preferred Shares shall be entitled, subject to and upon compliance with the provisions of this Section 4, to require the Corporation to redeem all or any part of the Series B Senior Preferred Shares registered in the name of that holder on July 1, 1992 (the "Retraction Date") at a price equal to \$25.00 per share, plus all accrued and unpaid dividends thereon calculated to but excluding the Retraction Date (the whole being referred to for the purpose of these provisions as the "Retraction Price").

4.2 Procedure

(a) The Corporation shall itself or through the transfer agent for the time being of the Series B Senior Preferred Shares, at least 60 and not more than 90 days prior to the Retraction Date, give written notice of the right provided for in Section 4.1 to each person who is at the date of the giving of such notice a registered holder of Series B Senior Preferred Shares. Such notice shall set out the Retraction Price, the particulars of the procedure to be followed by any holder wishing to exercise such right, including the date (the "Deposit Date"), which shall be not later than the close of business on the date 30 days prior to the Retraction Date, on or before which any shares to be redeemed must be tendered, the place and manner of exercise of such right as hereinafter set out. Such notice shall also contain a brief statement of the terms, if any, on which any Series B Senior Preferred Shares may be converted into shares of Additional Series as provided in Section 5, a description of the material attributes of such additional shares and the place or places at which the holders of Series B Senior Preferred Shares may present and surrender such shares for conversion. Each holder of Series B Senior Preferred Shares who elects to require the Corporation to redeem all or any Series B Senior Preferred Shares registered in the name of that holder must, following receipt of such notice and prior to the close of business on the Deposit Date, deposit the certificate or certificates representing the Series B Senior Preferred Shares which that holder desires to have redeemed with the Corporation, with the retraction panel on the certificates duly completed and signed, at its registered office, at any place where the Series B Senior Preferred Shares may be transferred or at such other place or places in Canada as shall be specified in writing by the Corporation to the holders of the Series B Senior Preferred Shares in the aforementioned written notice. Any such certificates received by the Corporation at its registered office or oth-

erwise deposited in accordance with such notice at any place other than a transfer office of the transfer agent shall be forthwith delivered to the transfer agent.

(b) If a holder of Series B Senior Preferred Shares wishes to tender pursuant to the above retraction privilege a part only of the Series B Senior Preferred Shares represented by any share certificate or certificates, the holder may deposit the certificate or certificates with the Corporation, with the retraction panel on the certificates duly completed and signed. If less than all of the Series B Senior Preferred Shares represented by any certificate or certificates so endorsed are to be redeemed, the Corporation shall issue and deliver to such holder, at the expense of the Corporation, a new share certificate representing the Series B Senior Preferred Shares which are not being tendered for redemption.

4.3 Redemption Subject to Applicable Law

(a) If the redemption by the Corporation of all Series B Senior Preferred Shares required to be redeemed on the Retraction Date under this Section 4 would be contrary to applicable law or the rights, privileges, restrictions and conditions attaching to any shares of the Corporation ranking prior to the Series B Senior Preferred Shares, the Corporation shall redeem only the maximum number of Series B Senior Preferred Shares (rounded to the next lower multiple of 1,000 shares) which the Corporation determines it is then permitted to redeem. Such redemption will be made pro rata (disregarding fractions of shares) from each holder of tendered Series B Senior Preferred Shares according to the number of Series B Senior Preferred Shares tendered for redemption by each such holder and the Corporation shall issue and deliver to each such holder a new share certificate, at the expense of the Corporation, representing the Series B Senior Preferred Shares not redeemed by the Corporation. Thereafter, the Corporation shall redeem at the Retraction Price on each succeeding Dividend Payment Date such further number of Series B Senior Preferred Shares which have been deposited by holders thereof in accordance with Section 4.1 (excluding the provisions thereof as to the timing of deposit) on or before the 30th day preceding each such Dividend Payment Date, which is the lesser of (i) the number of Series B Senior Preferred Shares so deposited, and (ii) the maximum number of such Series B Senior Preferred Shares (rounded, except for the final redemption of any number of shares less than 1,000, to the next lower multiple of 1,000 shares and selected pro rata (disregarding fractions of shares) from each holder of Series B Senior Preferred Shares so tendered according to the number of Series B Senior Preferred Shares so tendered by each such holder) which the Corporation determines it is then permitted to redeem, and so on until all Series B Senior Preferred Shares which have been deposited for redemption under this Section 4 have been redeemed. The Corporation shall be under no obligation to give any notice to the holders of Series B Senior Preferred Shares in respect of the redemptions provided for in this Section 4.3 except for the notice provided for in paragraph (b) of Section 4.4.

(b) If the directors of the Corporation have acted in good faith in making any of the determinations referred to above as to the number of Series B Senior Preferred Shares which the Corporation is permitted at any time to redeem, the Corporation shall have no liability in the event that any such determination proves inaccurate.

4.4 Election Irrevocable

(a) Subject to paragraph (b) of this Section 4.4, the election of any holder to require the Corporation to redeem any Series B Senior Preferred Shares shall be irrevocable upon receipt by the transfer agent for the Series B Senior Preferred Shares of the certificates for the shares to be redeemed and the signification of election of the holder as aforesaid.

(b) To the extent that payment of the Retraction Price is not made by the Corporation on or before the Retraction Date, the Corporation shall forthwith after that date notify each holder who has not received payment for his deposited Series B Senior Preferred Shares of the holder's right to require the Corporation to return all (but not less than all) of the holder's deposited share certificates to the holder (and the Corporation shall return such cer-

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tificates on the request of the holder) and of the holder's rights under Section 4.3 hereof.

4.5 Not affecting Dividends

The inability of the Corporation to effect a redemption in whole on the Retraction Date or a subsequent Dividend Payment Date shall not affect or limit the obligation of the Corporation to pay any dividends accrued or accruing on the Series B Senior Preferred Shares from time to time not redeemed and remaining outstanding.

4.6 Payment and Retraction Procedure

Subject to Section 4.3, the Corporation shall redeem on the Retraction Date all of the Series B Senior Preferred Shares tendered pursuant to the above retraction privilege at the Retraction Price and except as otherwise specifically provided in this Section 4, redemptions under this Section 4 shall comply with and be subject to those provisions of paragraphs (b) to (f) inclusive of Section 3.3 not inconsistent herewith.

8 Article 3 is the provision for redemption at the option of the company. Article 3.3(e), which by art. 4.6 is made applicable to retractions if not inconsistent with art. 4, provides:

3.3(e) From and after the date fixed for redemption, the Series B Senior Preferred Shares called for redemption shall cease to be entitled to dividends or any other participation in the assets of the corporation and the holders thereof shall not be entitled to exercise any of their other rights as shareholders in respect thereof unless payment of the price fixed for redemption shall not be made upon presentation and surrender of the share certificates representing such shares in accordance with the foregoing provisions, in which case the rights of such holders shall remain unaffected.

9 One of the rights of the Series B Senior Preferred Shares is the right to vote for the election of two directors in the event that the company fails to make eight quarterly dividends. By art. 4.5 specifically, dividends continue to accrue on shares not redeemed in accordance with the retraction and "remaining outstanding".

10 Finally by art. 7 of the Provisions, on liquidation, dissolution or winding up of the corporation, the holders of the Series B Senior Preferred Shares are entitled to receive from the assets \$25 per share plus all unpaid dividends in priority to lower ranking shareholders, and are not entitled to any further distribution of assets.

11 The provisions attaching to the Series A and B Junior Preferred Shares are essentially similar to those for the Series B Senior Preferred except that the retraction date is any time after September 27, 1994.

12 All of the retraction privileges are made subject to applicable law, which for the purposes of Central Capital, a *Canada Business Corporations Act*, R.S.C. 1985, c. C-44 corporation, means subject to s. 36 of the CBCA which provides:

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

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

(a) the corporation is, or would after the payment be, unable to pay its liabilities as they become due; or

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(b) the realizable value of the corporation's assets would after the payment be less than the aggregate of

(i) its liabilities, and

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

Section 42 similarly restricts the declaration or payment of dividends:

42. [Dividends.] A corporation shall not declare or pay a dividend if there are reasonable grounds for believing that

(a) the corporation is, or would after the payment be, unable to pay its liabilities as they become due; or

(b) the realizable value of the corporation's assets would thereby be less than the aggregate of its liabilities and stated capital of all classes.

13 In December 1991, Central Capital stopped paying interest and principal on its unsecured loans, and from that time it was insolvent.

14 On April 23, 1992, Central Capital gave the required 60-day notice to the Series B Senior Preferred shareholders of their right to redeem on July 1, 1992, but advised that although they could tender their shares by May 29, 1992, the company would not be redeeming as any such redemption would be contrary to law in light of the current financial position of the company.

15 James McCutcheon and Central Guaranty deposited their shares as required.

16 On application of its lenders, an order was made in this court on June 15, 1992 declaring that the *Companies' Creditors Arrangement Act* applied to Central Capital and staying all proceedings against the company. On July 9, 1992, a further order was made whereby certain significant assets of the company would be transferred to Canadian Insurance Group Limited (CIGL), a newco, and the administrator was authorized to enter into a Subscription and Escrow Agreement with creditors of Central Capital whereby they could exchange a portion of their indebtedness for shares and debentures to be issued by CIGL. The administrator was to supervise the calling for claims of creditors. Central Capital was authorized to file a plan of arrangement with its secured and unsecured creditors and with its shareholders to provide for the restructuring of its debt and equity in accordance with the order. In respect of Central Capital shares, the order provided that the CCAA plan would provide for the conversion of all outstanding preference, common and subordinated voting shares into 10% of a new class of common shares to be created with the remaining 90% to be held by creditors of Central Capital. The July 9 order was made without prejudice to the rights of these appellants to claim as creditors of Central Capital.

17 No preferred shares were redeemed on July 1, 1992, and on July 20 Central Capital notified the holders of the Series B Senior Preferred Shares of their right to require the company to return the share certificates. James McCutcheon and Central Guaranty did not exercise that right.

18 On July 31, 1992, a further order of this court set June 15, 1992 as the date as at which all claims of creditors would be made and approved the proof of claim form. The claim is defined in the Restated Subscription and Escrow Agreement as follows:

"Claim" means any indebtedness, liability or obligation of any kind of CCC that, if unsecured, would be a debt

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provable in bankruptcy within the meaning of the Bankruptcy Act (Canada), as amended as of the date hereof.

19 Consolidated SYH did not have an opportunity to deposit its preferred shares for redemption because the earliest date for doing so in September, 1994 was well after the completion of the implementation of the plan of arrangement.

20 All of the appellants submitted claims to the administrator by the designated date, and their claims were denied. These appeals were brought in accordance with an order of September 22, 1992 approving the first report of the administrator which contained the appeal procedure.

21 By order of December 18, 1992, the CCAA plan was approved by the court and was made binding on all shareholders. On or about January 1, 1993, articles of reorganization in the form authorized by the sanction order were filed and a certificate of reorganization was issued. Pursuant to those articles, all common and preferred shares including those owned by the appellants were converted to a new class of common shares and the existing common and preferred shares were deleted from the Articles of Incorporation of Central Capital.

The Positions of the Parties

1. James McCutcheon and Central Guaranty

22 These appellants deposited their Series B Senior Preferred Shares for redemption in accordance with art.4 of the Provisions attaching to those shares before May 29, 1992. The deposit was irrevocable, and on July 1, 1992, the company was obliged to redeem those shares at the fixed redemption price. The company was restricted from actually paying for the shares on that date because it did not meet the solvency requirements of the CBCA, and therefore of art.4, which makes the retraction right "subject to applicable law", but the inability of the company to pay does not derogate from its obligation to pay and therefore from the characterization of that obligation on that date as a debt.

23 Furthermore, in assessing the nature of the entire transaction whereby the preference shares were issued in partial consideration for the sale of the shares of the insurance company to Central Capital, that transaction should be characterized as a loan, and not as an investment in capital. The loan earned a return in the form of the quarterly cumulative dividends attached to the shares, and was repayable if called by the lender, on July 1, 1992.

2. Consolidated S.Y.H.

24 This appellant's position is that its right to require Central Capital to retract its Series A and B Junior Preferred Shares on or after September 27, 1994 is a "claim provable" within the meaning of s.121 of the *Bankruptcy Act*, R.S.C. 1985, c.B-3 in accordance with the definition of "claim" in the Restated Subscription and Escrow Agreement.

25 Section 121 provided:

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

(2) The court shall, on the application of the trustee, determine whether any contingent claim or any unliquidated claim is a provable claim, and, if a provable claim, it shall value the claim, and the claim shall after that valuation be deemed a proved claim to the amount of its valuation.

(3) A creditor may prove a debt not payable at the date of the bankruptcy and may receive dividends equally with

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the other creditors, deducting only thereout a rebate of interest at the rate of 5 per cent per annum computed from the declaration of a dividend to the time when the debt would have become payable according to the terms on which it was contracted.

(4) Where a proposal is made before a bankruptcy, the claims provable shall be determined as of the date of the filing of the proposal.

26 The appellant's position is that the retraction right constitutes a future contingent liability of the company and is therefore a debt provable in bankruptcy. Although the company is prohibited from making payment to redeem the shares, the company is not relieved of its obligation to redeem. This appellant also says that the restrictions on redemption based on solvency are not applicable in the context of a restructuring.

3. The Unsecured Creditors

27 The unsecured creditors oppose the position that the appellants as preferred shareholders should be entitled to claim as creditors and thereby share in the significant assets together with the creditors. Their position is that the retraction right does not create a debt provable in bankruptcy. Furthermore, the appellants' interest in the company is in the nature of an investment in capital and therefore an equity interest, not a loan or debt interest.

28 In the case of Consolidated S.Y.H., because Central Capital was reorganized before the retraction date, no obligation to retract ever arose nor was it triggered. In the alternative, if the retraction rights amount to a claim, they are contingent claims only which must be valued at 0 because no payment can be made on them if the company is insolvent, and there is no prospect of the company becoming legally obligated to pay such claim, or in the further alternative, the appellants are at most "subordinated creditors" as defined in the Restated Subscription and Escrow Agreement.

29 These last two alternative submissions are somewhat problematic in light of the agreed statement of facts, para.2:

Issue

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

4. The Administrator

30 The administrator took no position before the court but had taken its position by denying the claims of the appellants.

Analysis

Is there a debt provable in bankruptcy?

31 A definition of "debt" in *Black's Law Dictionary*, 1990, 6th ed., at p.409 is:

A sum due by certain and express agreement. A specified sum of money owing to one person from another, in-

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cluding not only obligation of debtor to pay but right of creditor to receive and enforce payment.

32 The retraction right is clearly created in such a way that the obligation of the company to pay all or any part of the redemption price for deposited shares is contingent on compliance with applicable law which means the solvency tests set out in the CBCA. Because no payment can be made by the company unless the solvency requirements are met, until then there is no present obligation to pay.

33 The company's obligation is to retain the shares that have not been returned to the holder at its request, and to redeem them by paying the redemption price when and if the solvency conditions are met. Until that time there is no debt that can be enforced by action resulting in a money judgment.[FN1] The only action that might be brought would be for a declaration of the obligation of the company to make payment in accordance with the terms of the share provisions.

34 The retraction right cannot be considered to be a contingent claim because until the shares are actually redeemed by payment, they remain outstanding as shares. This is clear from the terms of the share provisions including art.4.5 which refers to the shares not redeemed "and remaining outstanding" as maintaining their rights to dividends, and art.4.6 which incorporates art.3.3(e) which provides that unredeemed shares maintain all of their rights unaffected.

35 Counsel for Mr. McCutcheon submitted that art.3.3(e) is inconsistent with art.4 and therefore inapplicable to the retraction procedure, because the election to deposit the shares for retraction is irrevocable by the preferred shareholders, therefore they have irrevocably given up their rights as shareholders. However, the effect of the irrevocable election is that the shares remain deposited and will be redeemed as soon as such redemption is not contrary to law. That does not affect their status in the interim which is governed by art.3.3(e).

36 If this were a contingent claim in the sense of a future debt provable in bankruptcy, then any preferred shareholder whose shares have a fixed value on wind-up or dissolution of the company could be said to have a contingent claim to the value of those shares, contingent on a wind-up and on the company having sufficient funds on wind-up to redeem those shares. This is directly contrary to the principle referred to in Houlden and Morawetz, *Bankruptcy and Insolvency Law of Canada*, 3rd ed., vol.1, p.5-34 [G§28]:

If a person contributes capital to a business, even though that person is not a partner in the business and may have received no share of the profits, he cannot prove his claim in bankruptcy in competition with the creditors of the business. Although such a claimant may have a valid claim for the return of the investment funds, he cannot rank *pari passu* with the unsecured creditors. He would likely have an equitable right to share in the distribution of the assets but only at such time as the remaining unsecured creditors have been paid in full. It is of the utmost importance to determine the basis of the infusion of the monies: *Canada Deposit Insurance Corp. v. Cdn. Commercial Bank* (1987), 67 C.B.R. (N.S.) 136, reversed on other grounds, ... [1992] 3 S.C.R. 558 ..., applying *Laronge Realty Ltd. v. Golconda Investment Ltd.* (1986), 63 C.B.R. (N.S.) 76 ... (C.A.).

37 It is the two factors: (1) the solvency condition precedent to the obligation of the company to redeem, together with (2) the continued life of the shares as shares until the actual redemption takes place, which distinguish this case from *Re East Chilliwack Agricultural Co-operative* (1989), 74 C.B.R. (N.S.) 1 (B.C. C.A.), a case relied on by the appellants as determinative of the case at bar.

38 There the appellants had been members of a co-operative association. The co-operatives were governed by legislation. Pursuant to s.15 of the *Cooperative Association Act*, an association could redeem its own shares subject to its rules. The Agricultural Co-operative provided in its rules that a member could withdraw from the co-op by giving notice in writing. Then [at p.5] "[u]pon notice of withdrawal being given *membership in the Co-op shall cease* (emphasis added) and thereupon the shares of such member shall be redeemed, provided that the proceeds of redemption of such shares and any loans owing to such member arising from the operation of Rule 8.09, may be held for a period

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not exceeding five (5) years."

39 The members had two payment options upon redemption, the first to be paid in five equal instalments over the succeeding five years, the second to be paid at the end of five years with interest. At the date of the proposal in that case there were 156 members with shares under redemption.

40 The chambers judge had found that the redeeming shareholders were only entitled to money if the co-op had earnings. However, the Court of Appeal majority could find no authority in support of this finding and rejected it. The only possible reference may be the fact noted by the dissenting Justice in the Court of Appeal that dividends could only be declared out of profits.

41 The majority relied on the fact that the appellants ceased to be shareholders when they delivered the notice of withdrawal, and that thereafter their only interest in the co-op was for payment of the redemption amount. Therefore when the payments became due, they were owed by the co-operative and the appellants could sue for them if the co-operative failed to pay. The court held that the appellants were entitled to rank as unsecured creditors of the co-op.

42 In this case, the company is precluded from making payment unless the solvency tests are satisfied, plus the appellants remain shareholders of Central Capital until the shares are actually redeemed by payment. They retain their right to accruing dividends, and other rights. These two critical differences distinguish the present case from the decision in *East Chilliwack*, where the shareholders' status changed when they delivered their notices of redemption from shareholders to creditors. In this case, the status of the preferred shareholders does not change until they are redeemed by payment, at which time they have no further relationship with Central Capital.

43 The appellants also submit that the purpose of the CBCA restrictions on redemption is to prevent a preference in an insolvency situation, but that that concern is overridden once the court is involved in a restructuring or reorganization of the entire capitalization of the company allowing the company to carry on and not be wound up. Therefore in a restructuring situation the solvency restrictions for redemption can be ignored. This was done by Blair J. in *Re Olympia & York Developments Ltd.* (1993), 102 D.L.R. (4th) 149 (Ont. Gen. Div.) at p.163, where certain shares were to be redeemed by an insolvent company as part of a larger arrangement approved by the court. However, this is quite different from ignoring conditions specifically attaching to preference shares for the purpose of interpreting the nature of the rights contained in those shares.

44 The appellants are concerned that their right of retraction attaching to the preferred shares was eliminated by the orders implementing the Restated Subscription and Escrow Agreement and the Plan of Arrangement. However, any remedy for that concern would have been in the proceedings resulting in those orders, including any appeals.

45 Once the claims procedure was approved by the court, then the nature of the claim of each claimant is to be considered based on the facts applicable to that claim. There is no basis to ignore or read out the condition precedent for payment of the redemption price on retraction contained in the Provisions attaching to the preferred shares, for the purpose of determining the nature and extent of the retraction right and whether it constitutes a claim provable in bankruptcy.

46 Analyzing in another way whether the appellants have a contingent claim, the concept of a contingent claim should be considered in the context of the *Bankruptcy Act* in which it is found. It is difficult to postulate that a future obligation to pay which can only arise if the company is solvent at a point in time in the future could be a legitimate contingent future claim under the *Bankruptcy Act*, which in most cases is invoked because of the insolvency of the debtor, and crystallizes that insolvent state. In other words such a contingency is so remote as to be virtually non-existent. That was certainly the case with Central Capital in June, 1992.

47 The remoteness of the contingency is the basis for the alternative submission on behalf of the creditors that if

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the appellants do have a claim it can have no value. Because I have held that they have no claim, there is no need to deal with this alternative.

48 Finally, both sides put strong reliance on the Supreme Court of Canada decision in *Canada Deposit Insurance Corp. v. Canadian Commercial Bank*, [1992] 3 S.C.R. 558 which dealt with the characterization of the interest of certain institutions which provided funds to the Canadian Commercial Bank to try to prevent its failure. When the bank ultimately had to be wound up, the character of the interest of those institutions as debt or equity had to be determined in order to rank their claim in the winding up of the bank as either creditors or investors.

49 In that case, the documentation which was put in place when the monies were provided did not state specifically whether the monies were a loan or an infusion of capital. The circumstances surrounding the transaction were unique. However, the court recognized that it had characteristics of both debt and equity, which "duality is apparently quite common in loan participation agreements." (p.589) The court identified the arrangement as "one of a hybrid nature, combining elements of both debt and equity but which, in substance, reflects a debtor-creditor relationship." (p.590)

50 The various series of preferred shares of Central Capital are clearly characterized as preferred shares and the provisions applicable to them are set out in the articles of the company.

Preferred shares have been called "compromise securities" as having an intermediate position between common shares and debt. The hope has been that preferred would take on some of the characteristics of both debt and common shares, and theoretically at least, this can be achieved. ... the company cannot issue "secured" preferred shares in the sense that shares cannot have a right to a return of capital which is equal or superior to the rights of creditors. Preferred shareholders are risk-takers who are required to invest capital in the business and who can look only to what is left after creditors are fully provided for. ... In short, a preferred shareholder always remains a shareholder.

Grover and Ross, *Materials on Corporate Finance*, p.47/48/49, ch.11 Equity.

Although the right of retraction at the option of the preferred shareholder may be less common than the usual right of the company to redeem at its option, that right is one of the incidents or provisions attaching to the preferred shares, but does not change the nature of those shares from equity to debt. The parties have characterized the transaction as a share transaction. The court would require strong evidence that they did not intend that characterization in order to hold that they rather intended a loan.

51 In my view, this case turns on whether the right of retraction itself creates a debt on the date the company becomes obligated to redeem even if it cannot actually redeem by payment on that date, or a contingent future debt on the same analysis, not on whether the preferred shares themselves with the right of retraction are actually debt documents.

52 Because the preferred shares remain in place as shares until the actual redemption, the appellants are not creditors and have no claim provable under the *Bankruptcy Act* (Canada), and the appeals are therefore dismissed. The parties may address the issue of costs either orally or in writing if they are not able to agree on that matter.

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

The contracting party is not made a creditor, but is entitled to be paid out ahead of shareholders because of the outstanding contract claim.

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Appeals dismissed.

FN* The corrigenda issued by the court on January 16 and 24, 1995 have been incorporated herein.

FN1 It is interesting to compare the scheme set out in s.40 of the CBCA for purchase of its shares by a corporation pursuant to a contract. Such a contract is specifically enforceable, subject to the defence by the company that to buy the shares would put it in breach of similar solvency tests set out in ss.34 and 35 dealing with a corporation's ability to purchase its own shares. Section 40(3) deals with the status of the contracting party pending enforcement of the contract:

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TAB 6

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

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Blue Range Resource Corp., Re

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

In the Matter of Blue Range Resource Corporation

Alberta Court of Queen's Bench

Romaine J.

Judgment: January 10, 2000

Docket: Calgary 9901-04070

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

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

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

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

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

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

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

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

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

Practice --- Parties — Standing

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

Cases considered by *Romaine J.*:

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

B.G. Preeco I (Pacific Coast) Ltd. v. Bon Street Holdings Ltd. (1989), 4 R.P.R. (2d) 74, 37 B.C.L.R. (2d) 258, 43 B.L.R. 67, (sub nom. *B.G. Preeco I (Pacific Coast) Ltd. v. Bon Street Developments Ltd.*) 60 D.L.R. (4th) 30 (B.C. C.A.) — referred to

Canada Deposit Insurance Corp. v. Canadian Commercial Bank, 5 Alta. L.R. (3d) 193, [1992] 3 S.C.R. 558, 16

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Gen. Div.) — referred to

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

Statutes considered:

Bankruptcy Code, 11 U.S.C. 1982

Generally — referred to

s. 510 — referred to

s. 510(b) — referred to

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

Generally — referred to

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

Romaine J.:

Introduction

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

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

Facts

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

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

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

(c) it paid for the Blue Range shares sought through the takeover bid by way of a share exchange: Blue Range shareholders accepting Big Bear's offer received 11 Big Bear shares for each Blue Range share;

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(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

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(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

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its status as a shareholder.

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

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

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

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

23 It is true that Big Bear does not claim rescission. 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 misrepresentations.

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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

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insolvency. This assumption was referred to by Laskin, J. in *Central Capital (supra)*, in legal textbooks (Hadden, Forbes and Simmonds, *Canadian Business Organizations Law* Toronto: Butterworths, 1984 at 310, 311), and has been explicitly recognized in American case law. The court in *Matter of Stirling Homex Corp.*, 579 F.2d 206 (U.S. 2nd Cir. N.Y. 1978) at page 211 referred to this assumption as follows:

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

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

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

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

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

38 The court in *Northwestern Trust Co.* (*supra* at page 419) in obiter dicta refers to a claim of rescission 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,

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

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

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

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

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

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

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

46 The Applicants also cite the case of Re U.S. Financial Inc., 648 F.2d 515 (U.S. 9th Cir. Cal. 1980). This case is

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

less useful, as it was decided primarily on the basis of the absolute priority rule, but while the case was not decided on equitable grounds, the court commented that support for its decision was found in the recognition of the importance of recognizing differences in expectations between creditors and shareholders when classifying claims (*supra* at page 524). The court also stated that although both creditors and shareholders had been victimized by fraud, it was equitable to impose the risks of insolvency and illegality on the shareholders whose investment, by its very nature, was a risky one.

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

48 In *THC Financial Corp.*, the claimants argued that since they had a number of possible causes of action in addition to their claim of fraud, they should not be 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 & Co.* (1896), [1897] A.C. 22 (U.K. H.L.) that corporations are separate and distinct entities from their shareholders. In my view, this is not in issue. What is being sought here is not to limit a tort action by a shareholder against a corporation but to subordinate claims made *qua* shareholder to claims made by creditors in an insolvency situation. That shareholder rights with respect to claims against a corporation are not unlimited has already been established by the cases on rescission and recognized by statutory limitations on redemption and retraction. In this case, the issue is not the right to assert the claim, but the right to rank with creditors in the distribution of the proceeds of a pool of assets that will be insufficient to cover all claims. No piercing of the corporate veil is being suggested or would result.

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

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

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

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

53 Big Bear also submits that the equitable principles that exist in U.S. law which have led the courts to ignore separate corporate personality in the case of subsidiary corporations are related to equitable principles used to subordinate shareholder claims. The basis for this submission appears to be a reference by the British Columbia Court of Appeal in *B.G. Preeco I (Pacific Coast) Ltd. v. Bon Street Holdings Ltd.* (1989), 43 B.L.R. 67 (B.C. C.A.) to the *Pepper v. Litton* case (*supra*) and the so-called "Deep Rock doctrine" under American law. I do not see a link between the comments made in *Pepper v. Litton* and referred to in *B.G. Preeco* on an entirely different issue and comments concerning the court's equitable jurisdiction in the case of claims by shareholders against insolvent corporations.

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

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

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

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

Issue #2

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

Summary of Decision

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

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

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 question were not made to them. In any event, Big Bear indicates that it does not claim for any damages caused by dilution of the shares. It also notes that a claim for dilution would not be the same as the face value of the shares issued in the share exchange, which is the amount claimed in the Notice of Claim.

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

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

67 The proper measure of damages in cases of misrepresentation is discussed in *S.M. Waddams, The Law of*

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

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.

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

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

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

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

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

Issue #3

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

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

Summary of Decision

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

Analysis

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

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

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: *R. v. Wilson* (1983), 4 D.L.R. (4th) 577 (S.C.C.) at 599). The effect of the two orders made by LoVecchio, J. is to prevent Big Bear from advancing its claim other than as identified in its Notice of Claim, which cannot reasonably be interpreted to extend beyond the claims for damages for negligent misrepresentation.

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

84 I note that LoVecchio, J. issued a judgment after this application was heard relating to claims for relief from the impact of the claims procedure established by the court by a number of creditors who filed late or wished to amend

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

their claims after the claims bar date of May 7, 1999 had passed. Although LoVecchio, J. allowed these claims, and found that it was appropriate in the circumstances to grant flexibility with respect to the applications before him, he noted that total amount of the applications made to him would be less than 1.4 million dollars, and the impact of allowing the applications was minimal to the remaining creditors. The applications before him do not appear to involve issues which had been the subject of previous court orders, as in the current situation, nor would they have the same implication to creditors as would Big Bear's claim. The decision of LoVecchio, J. in the circumstances of the applications before him is distinguishable from this issue.

Order accordingly.

END OF DOCUMENT

TAB 7

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

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

National Bank of Canada v. Merit Energy Ltd.

NATIONAL BANK OF CANADA, BANK ONE, NA AND BANK ONE, CANADA (Plaintiffs) and MERIT ENERGY LTD. (Defendant) and IN THE MATTER OF THE BANKRUPTCY OF MERIT ENERGY LTD.

Alberta Court of Queen's Bench

LoVecchio J.

Heard: April 30, 2001

Judgment: July 3, 2001[FN*]

Docket: Calgary 0001-04994, Bankruptcy No. 073154

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William E. McNally, David A. Klein, for Larry Delf, Representative Flow-Through Shareholder

Jim G. Shea, for Flow-Through Shareholders who are not members of the Representative Class

Norman D. Anderson (Agent), for Magellan Aerospace Limited, Canada Dominion Resources Limited Partnership III

Matthew R. Lindsay, Phil J. Schreiber, for Underwriters except, First Energy Capital Corporation

Tristram Mallet, for First Energy Capital Corporation

Douglas G. Stokes, for certain Directors

D. Detomasi, for Barry Stobo

Jeff Sharpe, for Duncan Chisholm, Laurence Waller

Graham McLennan, for PriceWaterHouseCoopers LLP

Steven H. Leidl, for National Bank of Canada, Bank One, NA, Bank One Canada

Subject: Insolvency; Corporate and Commercial; Torts

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

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

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

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

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

Cases considered by *LoVecchio J.*:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Statutes considered:

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

Generally — referred to

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

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

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

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

Generally — referred to

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

Generally — referred to

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

LoVecchio J.:

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

INTRODUCTION

1 On August 31, 2000, applications were brought by Dundee Securities Corporation, Peters & Co. Limited, Nesbitt Burns Inc., Newcrest Capital Inc., RBC Dominion Securities, Bunting Warburg Dillon Read Inc., First Energy Capital Corporation (being the underwriters in the flow-through common share offering of Merit Energy Ltd., described below), certain directors and officers of Merit Energy Ltd. and Larry Delf, a representative purchaser of flow-through common shares in Merit, to determine whether these applicants were entitled to a priority in the nature of an equitable lien over the proceeds of the sale of Merit's assets.

2 I dismissed the equitable lien applications. The Underwriters, except First Energy Capital Corporation, appealed that decision.

3 Needless to say, the applicants wanted to be recognized as ordinary creditors of Merit in the event they did not have an equitable lien.

4 Pending the hearing of the equitable lien appeal, the administration of the estate of Merit continued. As a result of my dismissal of the equitable lien claim, the Trustee anticipated that a fund of approximately \$10 million would be available for distribution to unsecured creditors.

5 Accordingly, the Trustee sought a determination as to the right of the Flow-Through Shareholders, the Underwriters and the Directors and Officers to be recognized as ordinary creditors of Merit and to be included in the distribution.

6 I heard argument on that issue on April 30, 2001 but reserved my decision until the results of the appeal were known. On May 18, 2001, the appeal was heard and dismissed^[FN1], so it is now appropriate to make the requested determination.

7 The Trustee takes the position that the claims in issue are in substance claims by shareholders for the return of equity and, on the basis of the decision in *Blue Range Resource Corp., Re.*^[FN2], must rank behind the claims of Merit's unsecured creditors.

8 Alternatively, the Trustee argues that their claims are too contingent to constitute provable claims under the *Bankruptcy and Insolvency Act.*^[FN3]

9 The Flow-Through Shareholders, the Underwriters and the Directors and Officers^[FN4] submitted that their claims were in substance creditor claims and that they were not too contingent, thus qualifying them to rank as unsecured creditors in Merit's insolvency. If that position is sustained, the quantification of those claims will be a separate issue.

BACKGROUND

10 Merit was in the business of the exploration, development and production of natural gas and crude oil in Alberta and Saskatchewan.

11 On July 15, 1999, the Underwriters entered into an underwriting agreement with Merit whereby they agreed to participate in a public offering of 2,222,222 Flow-Through Shares of Merit. Paragraph 16 of the Underwriting Agreement states in part:

The Corporation shall indemnify and save each of the Indemnified Persons harmless against and from all liabil-

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ities, claims, demands, losses, (other than losses of profit in connection with the distribution of common shares), costs, damages and expenses to which any of the Indemnified Persons may be subject or which any of the Indemnified Persons may suffer or incur, whether under the provisions of any statute or otherwise, in any way caused by, or arising directly or indirectly from or in consequence of:

(a) any information or statement contained in the Public Record (other than any information or statement relating solely to one or more of the Underwriters and furnished to the Corporation by the Underwriters for inclusion in the Public Record) which is or is alleged to be untrue or any omission or alleged omission to provide any information or state any fact the omission of which makes or is alleged to make any such information or statement untrue or misleading in light of all the circumstances in which it was made;

(b) any misrepresentation or alleged misrepresentation (except a misrepresentation or alleged misrepresentation which is based upon information relating solely to one or more of the Underwriters and furnished to the Corporation by the Underwriters for inclusion in the Public Record) in the Public Record.

12 The Underwriting Agreement provides in Paragraph 2 (entitled "Corporation's Covenants as to Qualification") that:

[Merit] agrees:

(a) prior to the filing of the Preliminary Prospectus and thereafter and prior to the filing of the Prospectus, to allow the Underwriters to participate fully in the preparation of the Preliminary Prospectus (excluding the documents incorporated therein by reference) and such other documents as may be required under the Applicable Securities Laws in the Filing Jurisdictions to qualify the distribution of the Common Shares in the Filing Jurisdictions and allow the Underwriters to conduct all due diligence which the Underwriters may reasonably require (including with respect to the documents incorporated therein by reference) in order to (i) confirm the Public Record is accurate and current in all material respects; (ii) fulfill the Underwriters' obligations as agents and underwriters; and (iii) enable the Underwriters to responsibly execute the certificate in the Preliminary Prospectus or the Prospectus required to be executed by the Underwriters;

(b) the Corporation shall, not later than on July 19, 1999, have prepared and filed the Preliminary Prospectus...with the Securities Commissions...

(c) the Corporation shall prepare and file the Prospectus...as soon as possible and in any event not later than 4:30 p.m. (Calgary time) on August 3, 1999...

...

(e) that, during the period commencing with the date hereof and ending on the conclusion of the distribution of the Common Shares, the Preliminary Prospectus and the Prospectus will fully comply with the requirements of Applicable Securities Laws of the Filing Jurisdictions and, together with all information incorporated therein by reference, will provide full, true and plain disclosure of all material facts relating to the Corporation and the Common Shares and will not contain any misrepresentation; provided that the Corporation does not covenant with respect to information or statements contained in such documents relating solely to one or more of the Underwriters and furnished to the Corporation by one or more of the Underwriters for inclusion in such documents or omissions from such documents relating solely to one or more of the Underwriters and the foregoing covenant shall not be considered to be

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contravened as a consequence of any material change occurring after the date hereof or the occurrence of any event or state of facts after the date hereof if, in each such case, the Corporation complies with subparagraphs 3(a), (b), (c) and (d).

13 In accordance with its covenant, Merit filed a Preliminary Prospectus and a Prospectus to qualify the shares for issue and ultimately the offering closed on August 17, 1999, at which time 2, 222, 222 Flow-Through Shares of Merit were issued.

14 The Prospectus indicated that:

The gross proceeds of this Offering will be used to incur CEE in connection with the Corporation's ongoing oil and natural gas exploration activities. The Underwriters' fee and the expenses of this Offering will be paid from Merit's general funds...

The Flow-through Common Shares will be issued as "Flow-through Shares" under the Act. The Corporation will incur on or before December 31, 2000, and renounce to each purchaser of Flow-through Common Shares, effective on or before December 31, 1999, CEE in an amount equal to the aggregate purchase price equal to the aggregate purchase price paid by such purchaser.

Subscriptions for Flow-through Common Shares will be made pursuant to one or more subscription agreements ("Subscription Agreements") to made between the Corporation and one or more of the Underwriters or one or more sub-agents of the Underwriters, as agent for, on behalf of and in the name of the purchasers of Flow-through Common Shares...

15 The Prospectus also indicated that:

... Pursuant to the Subscription Agreements, the Corporation will covenant and agree (i) to incur on or before December 31, 2000 and renounce to the purchaser, effective on or before December 31, 1999, CEE in an amount equal to the aggregate purchase price paid by such purchaser for the Flow-Through Common Shares and (ii) that if the Corporation does not renounce to such purchaser, effective on or before December 31, 1999, CEE equal to such amount, or if there is a reduction in such amount renounced pursuant to the provision of the Act and as the sole recourse of the purchaser for such failure or reduction, the Corporation shall indemnify the purchaser as to, and pay in settlement thereof to the purchaser, an amount equal to the amount of any tax payable or that may become payable under the Act...by the purchaser as a consequence of such failure or reduction...

In respect of CEE renounced effective on December 31, 1999, and not incurred prior to the end of the period commencing on the date that the Subscription Agreement is entered into and ending on February 29, 2000, the Corporation will be required to pay an amount equivalent to interest to the Government of Canada. Any amount of CEE renounced on December 31, 1999 and not incurred by December 31, 2000 will result in a reassessment of deductible CEE to subscribers. However, interest in respect of additional tax payable under the Act by a purchaser of Flow-Through Common Shares will generally not be levied in respect of such reassessment until after April 30, 2001.

16 The Underwriters each entered into Subscription and Renunciation Agreements with Merit for the purchase of the Flow-Through Shares, containing the covenants described in paragraph 15 above.

17 Merit did not incur CEE as anticipated and in fact only approximately \$4 million (of the anticipated \$15 million of CEE) was renounced to the Flow-Through Shareholders prior to Merit being placed in receivership, leaving an \$11 million shortfall. As a result, those Flow-Through Shareholders, who anticipated tax deductions based on \$15 million of CEE, were potentially faced with a tax problem.

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18 The Directors and Officers entered into indemnity agreements with Merit, which state in part that:

To the full extent allowed by law, [Merit]...agrees to indemnify and save harmless the Indemnified Party, his heirs, successors and legal representatives from and against any and all damages, liabilities, costs, charges or expenses suffered or incurred by the Indemnified Party, his heirs, successors or legal representatives as a result of or by reason of the Indemnified Party being or having been a director and/or officer of [Merit] or by reason of any action taken by the Indemnified Party in his capacity as a director and/or officer of [Merit], including without limitation, any liability for unpaid employee wages, provided that such damages, liabilities, costs, charges or expenses were not suffered or incurred as a direct result of the Indemnified Party's own fraud, dishonesty or wilful default.

19 Merit, the Underwriters and the Directors and Officers have been named as defendants in several actions commenced throughout Canada by or on behalf of the Flow-Through Shareholders. These actions allege that Merit, the Underwriters, the Directors and Officers and PriceWaterhouseCoopers are liable to the Plaintiffs because of misrepresentations made in the Prospectus. The Plaintiffs seek, *inter alia*, damages against all defendants, rescission 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

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The claims of the Flow-Through Shareholders are subordinate to the claims of Merit's unsecured creditors as they are in 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 *Blue Range Resource Corp., Re.*

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

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

26 Romaine J. went on at pp. 177-184 to describe five policy reasons which justified the conclusion that shareholders' claims such as Big Bear's should be ranked behind the claims of Blue Range's unsecured creditors. In summary, they are:

(i) the claims of shareholders rank behind the claims of creditors in insolvency;

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(ii) creditors do business on the assumption that they will rank ahead of shareholders in the event of their debtor's insolvency;

(iii) shareholders are not entitled to rescind their shares on the basis of misrepresentation after the company has become insolvent;

(iv) United States jurisprudence supports the priority of creditors in "stockholder fraud" cases; and

(v) to allow the shareholders to rank *pari passu* with the unsecured creditors could open the floodgates to aggrieved shareholders launching misrepresentation actions.

27 *Canada Deposit Insurance Corp. v. Canadian Commercial Bank*^[FN5] is also central to this application. That case involved an issue of priorities with respect to the insolvency of the Canadian Commercial Bank. In an effort to preserve the bank, a participation agreement was entered into among the governments of Canada and Alberta, the Canada Deposit Insurance Corporation and six commercial banks. The sum of \$255 million was advanced and it was to be repaid by CCB out of certain portfolio assets and pre-tax income. The agreement promised an indemnity in the event of insolvency, and gave the participants a right to subscribe for shares in CCB at a named price.

28 The Supreme Court of Canada held that although the participation agreement contained both debt and equity features, it was, in substance, a debt transaction. 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 rescission or damages due to an alleged misrepresentation in the Prospectus (based on their statutory rights to these remedies as disclosed in the Prospectus). They also claim damages relating to lost tax benefits associated with the Flow-Through Shares. While this is a contractual remedy based on the Subscription and Renunciation Agreements, it also has elements of misrepresentation flowing from certain descriptive statements made in the Prospectus.

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

i. The Trustee's Position

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

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suggested that the essential allegation of the Flow-Through Shareholders in their actions is misrepresentation and that as a result of such misrepresentation they have suffered damages. The Trustee then described the remedy sought as, in essence, a claim for a return of equity. The Trustee suggested that the claim for the anticipated tax benefits was no more than a claim for a benefit that was ancillary to their shareholding interest. The Trustee also described the Flow-Through Shareholders' application to prove as unsecured creditors as an attempt to take a "second kick at the can", following the failure of their equity investment.

32 Using the reasoning of Romaine J. in *Blue Range Resource Corp., Re*, the Trustee argued that the claim of the Flow-Through Shareholders must be subordinated to Merit's unsecured creditors. The Trustee submitted that all five policy reasons listed in that case (and described above) are present in this case, emphasizing that the dividend will be reduced 20 to 27% (from 15 to 11-12 cents) if the Flow-Through Shareholders' claims are included in the unsecured creditors' pool and that the facts in this case favour subordination even more than the facts in *Blue Range Resource Corp., Re*, as some of the Flow-Through Shareholders are seeking to rescind their purchase of the Flow-Through Shares in their actions.

ii. The Flow-Through Shareholders' Position

33 Arguments were filed separately by Mr. McNally, as Counsel for Larry Delf (Mr. Delf being the designate of the Representative Flow-Through Shareholders group), and by Mr. Shea as Counsel for certain other Flow-Through Shareholders.

The Representative Flow-Through Shareholders Group's Position

34 Mr. McNally did not take issue with the suggestion that as a general rule, shareholders rank after secured creditors. He also did not object to the reasoning of Romaine J. in *Blue Range Resource Corp., Re*, provided the case is limited to its context and not used to stand for the general proposition that in no circumstances may a shareholder ever have a claim provable in bankruptcy.

35 Mr. McNally did object to the Trustee's characterization of the claim as a single claim for misrepresentation seeking damages equal to their purchase price for the shares. He suggested that the claims involved firstly, a right to damages or rescission *qua* shareholder under securities legislation and secondly, a right to damages for breach of an indemnity provision *qua* debt holder. He also submitted that this latter claim may also be seen as having nothing to do with misrepresentation in the Prospectus or a return of capital, but arises independently as a result of Merit's failure to incur and then renounce CEE to the shareholders to enable them to obtain certain tax deductions.

36 Mr. McNally suggested that this latter claim for tax losses was also a claim provable in bankruptcy. He referenced Laskin J.A.'s recognition in *Central Capital Corp., Re* [FN6] that shareholders may participate as creditors in the context of declared dividends because the liquidity provisions of corporate legislation would not have been triggered if the dividends had been declared prior to insolvency and would therefore be enforceable debts. Laskin J.A. stated at p.536:

It seems to me that these appellants must either be shareholders or creditors. Except for declared dividends, they cannot be both... Moreover, as Justice Finlayson points out in his reasons, courts have always accepted the proposition that when a dividend is declared it is a debt on which each shareholder can sue the corporation.

37 Mr. McNally also relied on *G.M.D. Vending Co., Re*[FN7] where the British Columbia Court of Appeal allowed declared but unpaid dividends to rank with other unsecured claims in a bankruptcy.

38 He also emphasized that the CEE aspect of the relationship between the Flow-Through Shareholders, on the one hand, and Merit, the Underwriters and the Directors and Officers, on the other, possesses many of the indicia of

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debt mentioned by Weiler J.A. in *Central Capital Corp., Re* in that: (1) Merit is obliged to expend the funds raised by the Prospectus on CEE and the funds are advanced by Flow-Through Shareholders for this specific purpose alone, (2) there is an indemnity provision in the Prospectus itself to the Flow-Through Shareholders if this does not occur, evidencing an intention that the investors are to be fully repaid for the loss of the tax benefit,[FN8] and (3) interest becomes due for the amount of the failed tax write-off and is covered by the indemnity provision as tax payable.

39 He suggested that the indemnity provisions in the Subscription and Renunciation Agreements are enforceable at law without consideration of corporate liquidity and are an acknowledgment of the unique commercial position of the Flow-Through Shareholders in the event that the CEE is not renounced. He concluded by submitting that the potential liquidity problem and contingent liability must constitute the rationale for the presence of the indemnity in the Subscription and Renunciation Agreements in the first place.

The Other Flow-Through Shareholders Group's Position

40 Mr. Shea suggested that not only were the claims for tax losses relating to the CEE provable claims, the tort/statutory aspects of their claims were also provable claims, albeit they would be dealt with as "contingent" claims within the meaning of ss. 121 and 135 of the BIA[FN9]. He further submitted that the fact they are claims by shareholders is irrelevant.

41 He relied on *Gardner v. Newton* [FN10] as authority for the proposition that a contingent claim is a claim that may or may not ripen into a debt depending on the occurrence of some future event. Mr. Shea also suggested that so long as the claim is not too remote or speculative, a claim, even though it has not yet been reduced to judgment, may still be a contingent claim. Mr. Shea pointed out that the Ontario Court of Appeal in *Confederation Treasury Services Ltd., Re*[FN11] departed from the earlier cases relied upon by the Trustee, including *Claude Resources Inc. (Trustee of) v. Dutton*[FN12]. The Court of Appeal stated they imposed too high of a threshold for the establishment of a contingent claim and held that it was not necessary to demonstrate probability of liability but merely to show they were not too remote or speculative.

42 He asserted that the claims are not shareholder claims, but claims for statutory remedies and for breach of contract and must rank with Merit's other unsecured creditors for that reason. Mr. Shea also said the Court must look to the substance of the relationship between the claimant and the bankrupt and most importantly, the context in which the claim is made.

43 Mr. Shea then argued that it would not be equitable to subordinate these claims while other claims based on tort, breach of contract or statutory remedy are allowed to rank as unsecured claims and concluded that the traditional principles for subordinating claims by shareholders do not apply to this case.

44 He suggested that allowing claims for statutory remedies and/or breach of contract based on misrepresentation to rank as unsecured claims will not affect how creditors do business with companies. Further, he argued that allowing this result will not "open the floodgates" as the statutory remedies involved are narrow in scope and have strict and relatively short time frames.

iii. The Underwriters' Position

45 Firstly, the Underwriters supported the Flow-Through Shareholders' submissions regarding the nature of their claims. They emphasized that *Blue Range Resource Corp., Re* should not stand for the proposition that shareholders must always be subordinated to unsecured creditors simply because they are shareholders. Rather, the nature and substance of their claims determines the treatment they receive in the estate.

46 The Underwriters also suggested that *Blue Range Resource Corp., Re* turned on its unique facts of a purchaser

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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 rescission and did not deny or attempt to avoid its shareholder status. Moreover, there was no contractual right to be treated by the company as anything but a shareholder.

47 The Underwriters distinguished the claims of the Flow-Through Shareholders from those of Big Bear in *Blue Range Resource Corp., Re* as follows: (1) the Flow-Through Shareholders are not pursuing tort claims based on their status as shareholders, but rather are asserting a statutory right of rescission, thereby refuting their status as shareholders, (2) the Flow-Through Shareholders also allege a direct contractual claim for indemnity against Merit pursuant to Subscription and Renunciation Agreements in which Merit agreed to incur qualifying expenditures (CEE), to renounce the resulting tax benefits to them and to indemnify them if it failed to incur the CEE, and (3) if their claims are ultimately successful, the Flow-Through Shareholders will be former shareholders and current creditors of Merit.

Resolution — ISSUE I

48 I agree with Romaine J. that the correct approach is to first examine the substance of the claim made against the insolvent. There are the two claims mentioned by counsel for the Flow-Through Shareholders. The first is an alternate remedy for damages or rescission 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 rescission or damages based on misrepresentation derive from their status as Merit shareholders. Regardless of how they are framed[FN13], the form the actions take cannot overcome the substance of what is being claimed. It is plain from the Prospectus and the Subscription and Renunciation Agreements that the Flow-Through Shareholders invested in equity. It is equally plain from their actions that what they seek to recoup, in substance, is their investments. As in *Blue Range Resource Corp., Re*, the "very core" of these claims arises from the circumstances surrounding the acquisition of Merit shares. The Flow-Through Shareholders had no cause of action until they acquired the Flow-Through Shares and their claims include a direct claim for return of capital in their request for rescission and in the case of a damage claim, just as in *Blue Range Resource Corp., Re*, the measure of damages enables them to recover the purchase price of the shares.

50 It is true these shareholders are using statutory provisions to make their claims in damages or rescission rather than the tort basis used in *Re: Blue Range Resource Corp.*, but in substance they remain shareholder claims for the return of an equity investment. The right to a return of this equity investment must be limited by the basic common law principle that shareholders rank after creditors in respect of any return of their equity investment.

51 Now what about the second aspect of the claims?

52 The second claim of the Flow-Through Shareholders has some of the features of a debt and the Subscription and Renunciation Agreements provide for a specific remedy in the event Merit fails to comply with its undertaking to make and renounce the CEE expenditures.

53 While the discussion in *Central Capital Corp., Re* regarding the claim for declared dividends is appealing, it does not precisely apply in these circumstances. The tax advantages associated with flow-through shares is reflected in a premium paid for the purchase of the shares[FN14]. In essence, what happens in a flow-through share offering (as sanctioned by the *Income Tax Act*[FN15]) is the shareholder buys deductions from the company. As the company has given up deductions, it wants to be paid for those deductions that it is renouncing. From the perspective of the purchaser of the shares, the premium for the shares would not have been paid without some assurance that the deductions will be available. I note the purchaser is also required to reduce their adjusted cost base of the shares (for tax purposes)

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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 *Blue Range Resource Corp., Re*. Alternatively, the Trustee asserted that the claims of the Underwriters and the Directors and Officers are so contingent they must be valued at nil.

ii. The Underwriters' Position

57 The Underwriters argued that regardless of how the Court characterized the Flow-Through Shareholders' claims, the Trustee cannot succeed against the Underwriters because: (1) the indemnity claims are based on contractual, legal and equitable duties owed to the Underwriters by Merit, to which the Flow-Through Shareholders are strangers and to which *Blue Range Resource Corp., Re* has no application; (2) equitable subordination has never been applied by Canadian courts and the Trustee cannot satisfy the test even if the court chooses to apply it, and (3) the Underwriters' claims are precisely the type of contingent claims contemplated by the BIA.

iii. The Directors' and Officers' Position

58 The Directors and Officers conceded that, while some of the potential liability they face is as a result of the Flow-Through Shareholders' claims against them, or via indemnity claims brought by the Underwriters and Auditors against them, their claim is simply a claim in contract that is not an effort to obtain a return of equity. They argued that the enforceability of the indemnity is not contingent on the source of the potential liability.

59 In any case, the Directors and Officers face claims other than from Merit's shareholders, which include: (1) a Saskatchewan action alleging the Directors and Officers assented to or 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

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

attempting to pass on shareholder claims, but rather they are making a contractual claim for all the potential liability they face, as the indemnity intends.

60 The Directors and Officers also suggested that, as with the Underwriters, some of the contingency in their claim under the indemnity has been realized to the extent of legal fees incurred in defending the various actions. In any case, they agreed with the Flow-Through Shareholders and Underwriters that a contingent claim need not be "probable" in order to be "provable" but need only something more than to "remote and speculative in nature".

61 Further, directors and officers require indemnities and commercial necessity dictates that these indemnities have real value.

Resolution — ISSUE 2

Nature of the Underwriters and the Directors' and Officers' claims against Merit

62 The fundamental premise of the Trustee's argument is that the Underwriters' indemnity simply "flows through" or "passes on" the Flow-Through Shareholders' claim to Merit. This ignores the nature of the causes of action being advanced by the Underwriters and the existence of a contractual indemnity freely given by Merit for good and valuable consideration. The Trustee did not suggest that the indemnity was invalid or unenforceable, rather, it argued that this valid and enforceable right should be treated as a "shareholders' claim" and subordinated. With respect, I cannot agree with the Trustee's position.

63 The Trustee's argument attempts to shift the Court's focus from the Underwriters' *claim against Merit* to the *claim being asserted against the Underwriters*, even though it is the former that the Trustee wants the Court to subordinate. The Flow-Through Shareholders' cause of action against the Underwriter's is predicated on the Underwriters' alleged failure to discharge a statutory duty and their liability is not contingent in any way on a successful claim by the Underwriters against Merit under the indemnity.

64 The Underwriters' indemnity claims against Merit are not made as a shareholder or for any return of investment made by the Underwriters. Rather, they are based on contractual, legal and equitable duties owed directly by Merit to the Underwriters. Similarly, the other causes of action advanced by the Underwriters against Merit in the Third Party Notice do not arise from any equity position in the company, but are based on agency, fiduciary and contractual relationships between the Underwriters and Merit, to which the Flow-Through Shareholders are strangers and are unavailable for them to assert.

65 For example, the Underwriters are entitled to an indemnity for defence costs even if the Flow-Through Shareholders' claims fail completely. The ultimate success or failure of the Flow-Through Shareholders' claims makes no difference to the existence and enforceability of this right against Merit.

66 As the Underwriters' claims are not claims for a return of equity, *Blue Range Resource Corp., Re* does not apply. That decision only addressed equity claims of shareholders and I am not prepared to extend its application to the claims of the Underwriters in the application before me, simply because the claims triggering an indemnity by the Underwriters against Merit were shareholders' claims.

67 As Firstenergy Capital Corp. emphasized, even if I were to apply the policy considerations for subordinating claims identified by Romaine J. in *Blue Range Resource Corp., Re* to the Underwriters' claims, these policy considerations support a conclusion that the Underwriters' claims are of the type I believe that Romaine J. would protect, not subordinate:

1. Shareholders rank behind creditors in insolvency - the issue here is whether the Underwriters are properly

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

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 *Canada Deposit Insurance Corp. v. Canadian Commercial Bank*, the Supreme Court of Canada expressly left open the question of whether equitable subordination formed part of Canadian insolvency law, but expressed its opinion as to the applicable test as developed in the United States:

...(1) the claimant must have engaged in some type of inequitable conduct; (2) the misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and (3) equitable subordination of the claim must not be inconsistent with the provisions of the bankruptcy statute...(p. 420)

An application of these criteria would lead to the conclusion that equitable subordination would not apply in this case, even if it was part of Canadian law.

Although the Trustee suggested that the Underwriters may have "participated" in the misrepresentation, there is

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

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*^{[FN]6} :

[t]his last requirement has been read as a "reminder to the bankruptcy court that although it is a court of equity, it is not free to adjust the legally valid claim of an innocent party who asserts the claim in good faith merely because the court perceives the result as inequitable"

This statement encapsulates what the Trustee is asking to the Court to do: subordinate the claims of the Underwriters, who have asserted their claims under their indemnities as they are entitled to do, merely because the result may be perceived as inequitable. The words of the US Supreme Court are consistent with the view that equitable subordination is an extraordinary remedy that ought to be employed only where there is some misconduct on the part of the claimant. The statutory scheme of distribution in the *BIA* must be paramount, and if it is to be interfered with, it should only be in clear cases where demonstrable inequitable conduct is present.

5. Floodgates - Romaine J. considered that allowing Big Bear's claim for misrepresentation to rank with unsecured creditors would encourage aggrieved shareholders to claim misrepresentation or fraud. This consideration has no application to the Underwriters, who are not shareholders. Allowing the Underwriters' claims, which are based on a contractual right of indemnity, will not open the door to increased claims of misrepresentation or fraud by shareholders. The nature of the claims against the Underwriters and the Underwriters' claim against Merit are entirely different.

68 In summary, the Underwriters' claims against Merit are creditors' claims which rank with Merit's other unsecured creditors.

69 With this result I appreciate the potential for the Flow-Through Shareholders to be seen as obtaining some recovery from the estate before all the unsecured creditors are paid in full. It might even be suggested it may ultimately allow the Flow-Through Shareholders to achieve indirectly what they could not achieve directly, based on the substance of their claims. This may be the final economic result.

70 However, success by the Flow-Through Shareholders against the Underwriters is not contingent upon success by the Underwriters against Merit nor does it automatically follow that success by the Flow-Through Shareholders against the Underwriters must inevitably lead to success by the Underwriters against Merit. A successful claim by the Underwriters against Merit will be determined on the basis of the provisions of the indemnity and the result of the claim against the Underwriters will be one of the factors in that analysis.

71 As the possible economic result described in paragraph 69 does not flow from a continuous chain of interdependent events, the possibility that the Flow-Through Shareholders may indirectly recover some of their equity investment from others prior to Merit's unsecured creditors being paid in full would not be a sufficient reason to decide this application differently.

72 As with the Underwriters, I find that the Directors and Officers have creditors' claims entitled to rank with Merit's other unsecured creditors.

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

Contingent claims

73 While the Trustee's primary argument was the claims of the Underwriters and the Directors and Officers are merely indirect shareholder claims, alternatively, it argued that these claims are too contingent and cannot constitute a provable claim on that basis.[FN17]

74 The Trustee relied on the case of *Claude Resources Inc. (Trustee of) v. Dutton* in support of its position. In that case, an indemnity agreement was executed between the bankrupt and its sole shareholder, officer and director and entitled the individual to be indemnified for any liabilities arising out of actions taken in his capacity as an officer and director of the bankrupt. This individual was sued in relation to a debenture offering and sought to prove using his indemnity. Noble J. described the claim as having a "double contingency", in that as a first step the action on the debenture offering must be successful, and if so, then the claim on the application of the indemnity agreement must also succeed. Noble J. held that more is needed beyond evidence that the creditor has been sued and that liability may flow; some element of probability is needed.

75 The Trustee submitted that there is no evidence as to the potential success of the Flow-Through Shareholders' claims against the Underwriters and/or the Directors and Officers, nor was it possible prior to judgment in those actions, to determine whether any liability of the Underwriters and/or the Directors and Officers to the Flow-Through Shareholders would qualify for indemnification.

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

77 Section 121 does not specify the degree of certainty required to make a claim provable, other than to include as provable all debts or liabilities to which the bankrupt may become subject. As stated, the Ontario Court of Appeal addressed this in *Confederation Treasury Services Ltd., Re* and held that the test of probable liability set out in *Claude Resources (Trustee of) v. Dutton* and *Wiebe, Re* (also relied on by the Trustee) imposed too high of a threshold to establish a valid contingent claim. Rather, the Ontario Court of Appeal expressed that contingent claims must simply be not too "remote or speculative in nature". I agree with the Ontario Court of Appeal's view of the test.

78 On a plain reading of the Underwriting Agreement, the indemnity appears to be engaged by the Flow-Through Shareholders' actions. The actions are under case management and are proceeding through discoveries at this time. Further, there are several authorities that suggest an indemnity becomes enforceable as soon as a claim of the type indemnified is alleged.[FN20] Finally, at least one part of the Underwriters' claim is not contingent - they have incurred costs and disbursements in defence of the Flow-Through Shareholders' claims and according to the terms of the indemnity are currently entitled to reimbursement for those costs, regardless of the outcome of the litigation.

iv. PriceWaterhouseCoopers

79 PriceWaterhouseCoopers made similar submissions to the Underwriters and the Directors and Officers and emphasized the strong policy reason behind supporting auditors' indemnities as unsecured and not subordinated claims. In addition, PriceWaterhouseCoopers has an independent claim for negligent misrepresentation against the Directors and Officers, arising out of the provision of information to PriceWaterhouseCoopers by Merit management which PriceWaterhouseCoopers alleges was known, or ought to have been known, to be incorrect. PriceWaterhouseCoopers suggested this further distinguishes PriceWaterhouseCoopers' situation from the situation before the Court in *Blue Range Resource Corp., Re*.

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

80 I find that PriceWaterhouseCoopers' indemnity claim is a creditor's claim entitled to rank with Merit's other unsecured creditors. My reasoning with respect to the Underwriters' claims, as based on their indemnities, applies equally to PriceWaterhouse Coopers' claim based on its indemnity.

81 I am aware that the indemnities of the Flow-Through Shareholders are not being accorded creditor status, while those of the Underwriters, the Directors and Officers and PriceWaterhouseCoopers are. However, as noted, the indemnity feature of the Flow-Through Shareholders' claims is related to certain deductions and those deductions were part of the purchase price for the shares. This in my view is more analogous to Canada Deposit Insurance Corp. v. Canadian Commercial Bank than to Central Capital Corp., Re and that to me is sufficient to justify the distinction.

CONCLUSION

82 The claims of the Flow-Through Shareholders are in substance claims for the return of equity investment and rank behind the claims of Merit's unsecured creditors, which shall include the claims of the Underwriters, the Directors and Officers and PriceWaterhouse Coopers.

83 If the parties cannot agree on costs, they may see me within 30 days.

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

Order accordingly.

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

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

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

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

FN4 PriceWaterhouseCoopers LLP, Merit's auditor at the material times, was not involved in previous applications but made similar submissions to the Underwriters, Directors and Officers. PriceWaterhouseCoopers' position will be addressed separately in these reasons.

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

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

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

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

FN9 121(1) All debts and liabilities, present or future, to which the bankrupt is subject on the day on which the bankrupt becomes bankrupt or to which the bankrupt may become subject before the bankrupt's discharge ...shall be deemed to be claims provable in proceedings under this Act. (2) The determination whether a contingent or unliquidated claim is a provable claim and the valuation of such a claim shall be made in accordance with section 135.

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

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

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

FN12 (1993), 22 C.B.R. (3d) 56 (Sask. Q.B.), referred to favourably by Farley J. in *Canadian Triton Interational Ltd. (Re)* (1997), 49 C.B.R. (3d) 192 (Ont. Bkcty.) and followed in *Wiebe, Re* (1995), 30 C.B.R. (3d) 109 (Ont. Bkcty.)

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

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

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

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

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

FN18 *ibid.*

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

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

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TAB 8

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

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

EarthFirst Canada Inc., Re

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

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

Alberta Court of Queen's Bench

B.E. Romaine J.

Heard: May 13, 2009

Judgment: May 27, 2009[FN*]

Docket: Calgary 0801-13559

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

Howard A. Gorman for EarthFirst Canada Inc.

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

Subject: Insolvency

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

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

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

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

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

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

Cases considered by B.E. Romaine J.:

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

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

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

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

Statutes considered:

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

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

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

Generally — referred to

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

Generally — referred to

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

B.E. Romaine J.:

Introduction

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

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

Facts

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

6.(b) to incur, during the Expenditure Period, Qualifying Expenditures in such amount as enables the Corporation to renounce to each Subscriber, Qualifying Expenditures in an amount equal to the Commitment Amount of such Subscriber;

(c) to renounce to each Subscriber, pursuant to subsection 66(12.6) and 66(12.66) of the Tax Act and this Subscription Agreement, effective on or before December 31, 2007, Qualifying Expenditures incurred during the Expenditure Period in an amount equal to the Commitment Amount of such Subscriber;

.....

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

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

Issue

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

Analysis

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

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

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

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

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

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

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

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

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

The Court of Appeal in dismissing the appeal commented:

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

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

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

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

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

Conclusion

I therefore grant:

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

Order accordingly.

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

END OF DOCUMENT

TAB 9

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

H

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

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

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

Ontario Superior Court of Justice [Commercial List]

Newbould J.

Heard: August 18, 2011

Judgment: August 25, 2011[FN*]

Docket: 09-CL-8172

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

Mathew Halpin, Evan Cobb for TA Associates Inc.

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

Subject: Corporate and Commercial; Insolvency

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

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

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did not acknowledge liability to indemnify creditors — Monitor did not knowingly approve payment of creditors' defence costs of arbitration.

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

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

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

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

Cases considered by *Newbould J.*:

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

Statutes considered:

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

Generally — referred to

s. 2(1) "equity claim" — referred to

s. 6(8) — considered

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

Newbould J.:

1 This is a motion brought by BDO Canada Limited in its capacity as the Court-appointed Monitor of Gandhi Innovations Limited, Gandhi Innovations Holdings LLC, Gandhi Innovations LLC, Gandhi Innovations Hold Co, and Gandhi Special Holdings LLC (the "Gandhi 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 Gandhi Group.

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

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

5 TA Associates Inc. is a general partner for a number of TA partners. In conjunction with the reorganization of Gandhi Holdings, it advanced approximately US \$75 million on September 12, 2007 by way of debt and equity to the Gandhi 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 Gandhi Holdings dated as of September 12, 2007 made between, among others, Gandhi 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 Gandhi 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 Gandhi 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 Gandhi Group in the approximate amount of \$76 million and a proof of claim of Trent Garmoe against the Gandhi Group in an approximate amount of \$88 million. The Claimants assert an entitlement to indemnification by the Gandhi 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 Gandhi Holdings and a separate Indemnification Agreement made by Gandhi Holdings entered into in connection with the Membership Agreement made at the time of the TA Associates investment with Gandhi Holdings. Gandhi Holdings is the only Gandhi entity that is a party to these indemnity agreements.

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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 Gandhi Holdings.

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

11 There is also an indemnity of Gandhi Innovations Hold Co ("Gandhi Hold Co"). At the relevant times James Gandhi 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 Gandhi Group, and learned that all of corporate governance documents of the Gandhi Group, at Hary Gandhi's request, had been sent to Stikeman Elliot LLP, insolvency counsel for the Gandhi 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 Gandhi Group, to inquire if it has in its possession copies of the Gandhi 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 Gandhi Group entities.

14 The Monitor also reviewed the books and records of the Gandhi Group in storage. In addition, the Monitor advised the Claimants that should they wish to undertake a review of the Gandhi 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 Gandhi 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 Gandhi Group or against only Gandhi Holdings and Gandhi Hold Co will assist the Monitor in determining whether to proceed with a consolidated plan of arrangement or file an alternative plan excluding Gandhi Holdings and/or Gandhi 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 Gandhi 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 Gandhi Holdings dated September 12, 2007 provides for an indemnity by Gandhi Holdings in section 6.8(a) for board members and officers. There is no

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dispute that the Claimants were officers and board members of Gandhi 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 Gandhi Holdings by that provision as well.

20 There is a form on indemnity agreement made between Gandhi 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 Gandhi, who swore an affidavit for the Claimants, said that a copy of this agreement was signed between Gandhi Holdings and each of the Claimants on September 12, 2007. It contains the following:

WHEREAS, the Company desires to provide Indemnitee with specific contractual assurance of Indemnitee's rights to full indemnification against litigation risks and related expenses (regardless, among other things, of any amendment to or revocation of the Company's LLC Agreement or any change in the ownership of the Company or the composition of its Board of Managers) ...

...

3. Agreement to indemnify... if Indemnitee was or is a party or is threatened to be made a party to any Proceeding by reason of Indemnitee's Corporate Status, Indemnitee shall be indemnified by the Company against all Expenses and Liabilities incurred"

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

22 The Claimants contend that each of the corporate entities in the Gandhi Group signed an indemnity in favour of each of them. This is based on a statement in the affidavit of Hary Gandy that Gandhi 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 Gandhi 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 Gandhi Holdings.

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

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

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(b) Memorandum and articles of Gandhi Hold Co

26 In the course of its investigation, the Monitor did locate an indemnity granted by Gandhi 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 Gandhi Innovations Limited articles, as discussed below. As the Monitor does not seek a determination regarding indemnities given by Gandhi 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 Gandhi 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 Gandhi 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 Gandhi 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 Gandhi 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 Gandhi Innovations Limited.

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

32 It is argued that the indemnity in the articles of Gandhi 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 Gandhi 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 Gandhi Holdings operated the subsidiaries as if they were officers and directors of the subsidiaries. Again, there is no documentary

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evidence of that and no evidence from any of the Claimants to support the assertion. While Hary Gandy may have operated the business in a functional sense, that does not mean that he was acting as an officer or director of any subsidiary in the corporate sense. This is not mere semantics. TA Associates made a large investment, and one of the corporate documents provided on closing was the Nova Scotia Registry of Joint Stock Companies that showed only James Gandy as an officer and director. If all of the Claimants are entitled to be indemnified by Gandi Innovations Limited, it will impact the claim of TA Associates in the CCAA proceedings.

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

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

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

(d) Other Gaudi Group entities

37 It was asserted by the Claimants that because the Gandi companies operated essentially as one integrated company, it should be inferred that the constating documents of the other entities in the Gandi Group contained 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 in-

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demnify the Claimants and it is said that this arises from a meeting of the board of Gandhi Holdings. It is argued that the Gandhi Group through the Monitor is thus estopped from denying an indemnity for all of the Gandhi Group companies. A document said to be minutes of a meeting of the board of managers of Gandhi 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 Gandhi 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 Gandhi Holdings. It says that it was generally agreed that all parties would follow the purchase agreement between Gandhi Holdings and TA resources dated September 12, 2007. That purchase agreement provides for an indemnity by only Gandhi 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 Gandhi Holdings swears that the Claimants voted to place Lydia Garay, a longtime employee and officer of Gandhi 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 Gandhi 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 Gandhi 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 Gandhi 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 Gandhi Group has previously acknowledged their liability to indemnify the Claimants for any damage, award or legal costs incurred by the following actions:

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(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,

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(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 Gandhi Group's CCAA proceedings which commenced shortly prior to the legislative amendments, courts have noted that the amendments codified existing case law relating to the treatment of equity claims in insolvency proceedings. In *Nelson Financial Group Ltd., Re* (2010), 75 B.L.R. (4th) 302 (Ont. S.C.J. [Commercial List]), Peppall 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 Gandhi 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 Gandhi Holdings.

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

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

This treatment also has been held to encompass fraudulent misrepresentation claims advanced by a shareholder seeking to recover his investment: *Re Blue Range Resource Corp.* In that case, Romaine J. held that the alleged loss derived from and was inextricably intertwined with the shareholder interest. Similarly, in the United States, the Second Circuit Court of Appeal in *Re Stirling Homex Corp.* concluded that shareholders, including those who had allegedly been defrauded, were subordinate to the general creditors when the company was insolvent.

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

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Order

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

Order accordingly.

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

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

ONTARIO
SUPERIOR COURT OF JUSTICE
(Commercial List)

Proceeding commenced at Toronto

BRIEF OF AUTHORITIES
(motion for an equity Claims Order,
returnable on June 26, 2012)

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