

**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**

**FACTUM OF THE AD HOC COMMITTEE OF NOTEHOLDERS
OF SINO-FOREST CORPORATION**

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I OVERVIEW

1. This factum is submitted in connection with the motion by Sino-Forest Corporation (“Sino-Forest”) seeking, among other things, a declaration that certain claims against Sino-Forest, which result from the ownership, purchase or sale of an equity interest in Sino-Forest, are “equity claims” as defined in section 2 of the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36, as amended (the “*CCAA*”) including, without limitation, (i) the claims by or on behalf of current or former shareholders asserted in the proceedings listed in Schedule “A” to Sino-Forest’s Notice of Motion (the “Shareholder Claims”), and (ii) any indemnification claims against Sino-Forest related to or arising from the Shareholder Claims, including, without limitation, by or on behalf of any of the other defendants to the proceedings listed in Schedule “A” to Sino-Forest’s Notice of Motion (collectively, the “Related Indemnity Claims”).

2. For the reasons set out in Sino-Forest's factum and below, the declaration sought should be granted.

II THE FACTS

3. The Ad Hoc Committee of Noteholders adopts and relies upon the statement of facts and, where a capitalized term is not defined herein, the definitions set forth in Sino-Forest's factum.

III THE LAW

A. Plain Language in Definition of "Equity Claim" Captures Shareholder Claims and Related Indemnity Claims

4. "Equity claim" and "equity interest" are broadly defined in the *CCAA* as follows:

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

(a) a dividend or similar payment,

(b) a return of capital,

(c) a redemption or retraction obligation,

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

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

"**equity interest**" means

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

CCAA, section 2, Ad Hoc Committee's Book of Authorities, Tab 1.

5. The *CCAA* was amended in 2009 to provide expressly for the subordination of equity claims. Section 6(8) of the *CCAA* prohibits a distribution to equity claimants prior to payment in full of all non-equity claims. Section 6(8) provides as follows:

6(8) No compromise or arrangement that provides for the payment of an equity claim is to be sanctioned by the court unless it provides that all claims that are not equity claims are to be paid in full before the equity claim is to be paid.

CCAA, section 6(8), Ad Hoc Committee's Book of Authorities, Tab 1.

6. Under section 22.1 of the *CCAA*, equity claimants are prohibited from voting on a plan, unless the court orders otherwise. Section 22.1 of the *CCAA* provides as follows:

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

CCAA, section 22.1, Ad Hoc Committee's Book of Authorities, Tab 1.

7. Parallel amendments that expressly subordinate equity claims were made to the *Bankruptcy and Insolvency Act*.

Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3, as amended, sections 2, 140.1 and 54.1, Ad Hoc Committee's Book of Authorities, Tab 2.

8. If claims fall within the parameters of the definition of "equity claim", "clearly they [are] to be treated as equity claims and not as debt claims."

Re Nelson Financial Group Ltd., (2010) ONSC 6229, 75 B.L.R. (4th) 302 [*Nelson Financial*] at para. 32 (retrieved from WL Can. on May 25, 2012), Ad Hoc Committee's Book of Authorities, Tab 4.

9. The Shareholder Claims are “equity claims” as they are claims in respect of an equity interest and are claims for “a monetary loss resulting from the ownership, purchase or sale of an equity interest” per subsection (d) of the definition of “equity claims” in the CCAA.

CCAA, section 2, Ad Hoc Committee’s Book of Authorities, Tab 1.

10. The Related Indemnity Claims are also “equity claims”. The Related Indemnity Claims fall within the “clear and unambiguous” language used in that definition. Subsection (e) of the definition of “equity claim” refers expressly, and without qualification, to claims for “contribution or indemnity” in respect of claims such as those advanced in the Shareholder Claims.

CCAA, section 2, Ad Hoc Committee’s Book of Authorities, Tab 1.

Nelson Financial at para. 34, Ad Hoc Committee’s Book of Authorities, Tab 4.

Return on Innovation Capital Ltd. v. Gandi Innovations Ltd., 2011 ONSC 5018, 2011 CarswellOnt 8590 (WL Can.) [*Return on Innovation*] at para. 55, leave to appeal to CA refused, *ROI Fund Inc. v. Gandi Innovations Ltd.*, 2012 ONCA 10, [2012] O.J. No. 31 (QL) (retrieved from WL Can. on May 25, 2012) [*ROI*] at para. 11, Ad Hoc Committee’s Book of Authorities, Tabs 5 and 6.

11. Had the legislators intended to qualify the reference to “contribution or indemnity” and exempt the claims of certain parties, they could have done so. They did not.

12. Further, if the plain language of subsection (e) is not upheld, shareholders of Sino-Forest could potentially create claims to receive indirectly what they could not receive directly (i.e., payment in respect of equity claims through the Related Indemnity

Claims) – a result that could not have been intended, and which would be inconsistent with the purpose of the CCAA.

B. Characterization of Indemnity Claims Turns on Characterization of Underlying Claims

13. The characterization of claims for indemnity turns on the characterization of the underlying claims; the former share the characterization of the latter. Applying this test, this Honourable Court in *Return on Innovation* recently characterized the contractual indemnification claims of directors and officers as “equity claims”. The Court of Appeal affirmed the Court’s characterization and denied leave to appeal.

Return on Innovation at paras. 56, 59 and 61, Ad Hoc Committee’s Book of Authorities, Tab 5.

14. The claims advanced in the Shareholder Claims, being the claims underlying the Related Indemnity Claims, are clearly equity claims. By extension under subsection (e) of the definition, and based on the test applied in *Return on Innovation*, so too are the Related Indemnity Claims.

C. The Scope of “Equity Claims” was Intended to be Expansive

15. Before the CCAA amendments in 2009 (the “CCAA Amendments”), courts subordinated claims on the basis of: (a) the general expectations of creditors and shareholders with respect to priority and assumption of risk; and (b) the equitable principles and considerations set out in the U.S. cases.

Blue Range Resource Corp., 2000 ABQB 4, 259 A.R. 30 [*Blue Range*] (retrieved from WL Can. on May 25, 2012), Ad Hoc Committee’s Book of Authorities, Tab 7.

16. Before the CCAA Amendments took effect, courts progressively expanded the types of claims characterized as equity claims – first to claims for damages of defrauded shareholders and then to contractual indemnity claims of shareholders.

Blue Range, Ad Hoc Committee’s Book of Authorities, Tab 7.

EarthFirst Canada Inc., 2009 ABQB 316, 56 C.B.R. (5th) 102 [*EarthFirst*] at para. 5 (retrieved from WL Can. on May 25, 2012), Ad Hoc Committee’s Book of Authorities, Tab 8.

17. The CCAA Amendments codified the treatment of the claims addressed in pre-amendment cases and further broadened the scope of equity claims.

Nelson Financial at para. 34, Ad Hoc Committee’s Book of Authorities, Tab 4.

ROI at para. 11, Ad Hoc Committee’s Book of Authorities, Tab 6.

Andrew Gray, “Equity Claims and the Reform of Insolvency Legislation” (June 2010) 22:5 *Commercial Insolvency Reporter* 48 at p. 52, Ad Hoc Committee’s Book of Authorities, Tab 9.

Janis Sarra, “From Subordination to Parity: An International Comparison of Equity Securities Law Claims in Insolvency Proceedings” (Winter 2007) 16:3 *INSOL International Insolvency Review* 181-246 [*Janis Sarra*] at pp. 208 and 210, Ad Hoc Committee’s Book of Authorities, Tab 10.

18. It is clear from the post-amendment case law that the identity of the claimant is not a determining factor; the plain language in the definition of “equity claim” and the nature of the claim underlying the indemnity claim are the key factors.

Return on Innovation at paras. 55 and 56, Ad Hoc Committee’s Book of Authorities, Tab 5.

19. It is also clear from the post-amendment case law that the “legal tool” involved (*i.e.*, contract claim or otherwise) is not a determining factor; “It is the fact that they are being used to recover an equity investment that is important.”

Return on Innovation at para. 59, Ad Hoc Committee's Book of Authorities, Tab 5.

D. Indemnity Claims of Underwriters have Been Treated as Equity Claims in the U.S.

20. The desire to more closely align the Canadian approach to equity claims with the U.S. approach was among the considerations that gave rise to the codification of the treatment of equity claims. Canadian courts have also looked to the U.S. law for guidance on the issue of equity claims where codification of the subordination of equity claims has been long-standing.

Janis Sarra at p. 209, Ad Hoc Committee's Book of Authorities, Tab 10.

Report of the Standing Senate Committee on Banking, Trade and Commerce, "Debtors and Creditors Sharing the Burden: A Review of the *Bankruptcy and Insolvency Act* and the *Companies' Creditors Arrangement Act*" (2003) at 158, Ad Hoc Committee's Book of Authorities, Tab 11.

Blue Range at paras. 41-57, Ad Hoc Committee's Book of Authorities, Tab 7.

21. Pursuant to § 510(b) of the *U.S. Bankruptcy Code*, all creditors must be paid in full before shareholders are entitled to receive any distribution. § 510(b) of the *U.S. Bankruptcy Code* and the relevant portion of § 502, which is referenced in § 510(b), provide as follows:

§ 510. Subordination

(b) For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such

security, except that if such security is common stock, such claim has the same priority as common stock.

§ 502. Allowance of claims or interests

(e) (1) Notwithstanding subsections (a), (b) and (c) of this section and paragraph (2) of this subsection, the court shall disallow any claim for reimbursement or contribution of an entity that is liable with the debtor on or has secured the claim of a creditor, to the extent that

...

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

...

(2) A claim for reimbursement or contribution of such an entity that becomes fixed after the commencement of the case shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section, or disallowed under subsection (d) of this section, the same as if such claim had become fixed before the date of the filing of the petition.

U.S. Bankruptcy Code § 510(b), § 502(e)(1)(B) and § 502(e)(2), Ad Hoc Committee's Book of Authorities, Tab 3.

22. U.S. appellate courts have interpreted the statutory language in §510(b) broadly to subordinate the claims of shareholders that have a nexus or causal relationship to the purchase or sale of securities, including damages arising from alleged illegality in the sale or purchase of securities or from corporate misconduct whether predicated on pre or post-issuance conduct.

Re Telegroup Inc. (2002), 281 F. 3d 133 (3rd Cir. U.S. Court of Appeals) (retrieved from LEXIS on May 25, 2012), Ad Hoc Committee's Book of Authorities, Tab 12.

American Broadcasting Systems Inc. v. Nugent, US Court of Appeals for the Ninth Circuit, Case Number 98-17133 (24 January 2001) (retrieved from LEXIS on May 25, 2012), Ad Hoc Committee's Book of Authorities, Tab 13.

23. Further, U.S. courts have held that indemnification claims of underwriters against the corporation for liability or defence costs when shareholders or former shareholders have sued underwriters constitute equity claims in the insolvency of the corporation that are subordinated to the claims of general creditors based on: (a) the plain language of §510(b), which references claims for “reimbursement or contribution;” and (b) risk allocation as between general creditors and those parties that play a role in the purchase and sale of securities that give rise to the shareholder claims (i.e., directors, officers and underwriters).

In re Mid-American Waste Sys., 228 B.R. 816, 1999 Bankr. LEXIS 27 (Bankr. D. Del. 1999) [*Mid-American*] (retrieved from LEXIS on May 25, 2012), Ad Hoc Committee’s Book of Authorities, Tab 14.

In re Jacom Computer Servs., 280 B.R. 570, 2002 Bankr. LEXIS 758 (Bankr. S.D.N.Y. 2002) (retrieved from LEXIS on May 25, 2012), Ad Hoc Committee’s Book of Authorities, Tab 15.

24. In *Mid-American*, the Court stated the following with respect to the “plain language” of § 510(b), its origins and the inclusion of “reimbursement or contribution” claims in that section:

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

...it is readily apparent that the rationale for section 510(b) is not limited to preventing shareholder claimants from

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

Mid-American at pages 7 and 9, Ad Hoc Committee's Book of Authorities, Tab 14.

25. Further, the U.S. courts have held that the degree of culpability of the respective parties is a non-issue in the disallowance of claims for indemnification of underwriters; the equities are meant to benefit the debtor's direct creditors, not secondarily liable creditors with contingent claims.

In re Drexel Burnham Lambert Group, 148 B.R. 982, 1992 Bankr. LEXIS 2023 (Bankr. S.D.N.Y. 1992) (retrieved from LEXIS on May 25, 2012), Ad Hoc Committee's Book of Authorities, Tab 16.

26. There is no principled basis to expect that indemnification claims by auditors should be treated differently than those of underwriters.

IV CONCLUSION

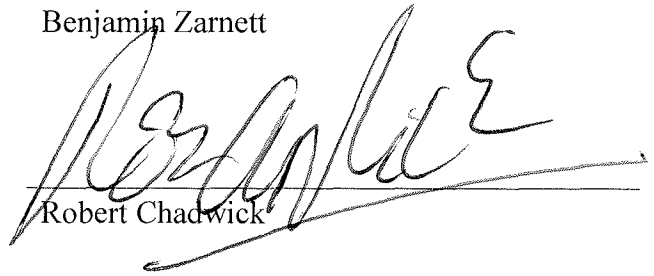
27. Based upon the plain language of the CCAA, the Shareholder Claims and the Related Indemnity Claims constitute “equity claims” within the meaning of the CCAA. This finding is consistent with the clear language of the statute and the trend towards an expansive interpretation of the definition of “equity claims” to achieve the purpose of the CCAA. This finding is also consistent with the case law and with U.S. case law from which relevant guidance can be taken, particularly in light of the desire to more closely align the Canadian approach to equity claims with the U.S. approach.

28. The Ad Hoc Committee of Noteholders requests that this Honourable Court declare that the Shareholder Claims and the Related Indemnity Claims are equity claims within the meaning of the CCAA.

ALL OF WHICH IS RESPECTFULLY SUBMITTED this 22nd day of June, 2012.

Benjamin Zarnett / per B.O'Neill

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SCHEDULE "A" - LIST OF AUTHORITIES

Re Nelson Financial Group Ltd., (2010) ONSC 6229, 75 B.L.R. (4th) 302.

Return on Innovation Capital Ltd. v. Gandi Innovations Ltd., 2011 ONSC 5018, 2011 CarswellOnt 8590 (WL Can.).

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In re Drexel Burnham Lambert Group, 148 B.R. 982, 1992 Bankr. LEXIS 2023 (Bankr. S.D.N.Y. 1992).

SCHEDULE "B" - LEGISLATION

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

Bankruptcy and Insolvency Act, R.S.C. 1985, c. B-3, as amended, sections 2, 140.1 and 54.1.

U.S. Bankruptcy Code, 11 USCS § 510(b), § 502(e)(1)(B) and § 502(e)(2).

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