Court File No.: CV15-10961-CL

***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 NELSON EDUCATION LTD. AND NELSON EDUCATION HOLDINGS LTD.

Applicants

# BOOK OF AUTHORITIES OF THE ROYAL BANK OF CANADA
## (Returnable on August 13, 2015)

August 11, 2015

**Thornton Grout Finnigan LLP**
Barristers & Solicitors
Suite 3200, TD West Tower
100 Wellington Street West
P.O. Box 329, Toronto-Dominion Centre
Toronto, ON M5K 1K7

**D.J. Miller** (LSUC# 34393P)
djmiller@tgf.ca
Tel: (416) 304-0559

**Kyla E. M. Mahar** (LSUC# 44182G)
kmahar@tgf.ca
Tel: (416) 304-0594
Fax: (416) 304-1313

Lawyers for Royal Bank of Canada

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# TAB 1

**CITATION:** Nelson Education Limited (Re), 2015 ONSC 3580
**COURT FILE NO.:** CV15-10961-00CL
**DATE:** 20150602

**SUPERIOR COURT OF JUSTICE – ONTARIO**
**COMMERCIAL LIST**

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

**AND IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF NELSON EDUCATION LTD. AND NELSON EDUCATION HOLDINGS LTD.**

Applicants

**BEFORE:** Newbould J.

**COUNSEL:** *Robert J. Chadwick, Caroline Descours and Sydney Young*, for the Applicants

*D.J. Miller and Kyla E.M. Mahar*, for the Royal Bank of Canada

*Kevin J. Zych,* for the First Lien Lenders

*Jay Swartz and Robin Schwill,* for Alvarez & Marsal Canada Inc.

**HEARD:** May 29, 2015

## ENDORSEMENT

[1] On May 12, 2015, Nelson Education Ltd. ("Nelson") and its parent company, Nelson Education Holdings Ltd. sought and obtained an initial order pursuant to the Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, as amended (the "CCAA"). Notice had been given to RBC only late the day before and RBC took the position that it had not had sufficient time to consider or prepare a response to the application. The resulting initial order was pared down from what was sought by the applicants and it provided that on the comeback date the hearing was to be a true comeback hearing and that in moving to set aside or vary any provisions

of the initial order, a moving party did not have to overcome any onus of demonstrating that the order should be set aside or varied.

[2] On the comeback date, RBC moved to have Alvarez & Marsal Canada Inc. ("A&M Canada") replaced with FTI Consulting Canada Inc. ("FTI") as the Monitor, and for other relief. At the conclusion of the hearing, I ordered that FTI replace A&M Canada as Monitor for reasons to be delivered. These are my reasons.

**Relevant History**

[3] Nelson is a Canadian education publishing company, providing learning solutions to universities, colleges, students, teachers, professors, libraries, government agencies, schools, professionals and corporations across the country.

[4] The business and assets of Nelson were acquired by an OMERS entity and certain other funds from the Thomson Corporation in 2007 together with U.S. assets of Thomson for U.S. $7.75 billion, of which US$550 million was attributed to the Canadian business. The purchase was financed with first lien debt of approximately US$311.5 million and second lien debt of approximately US$171.3 million.

[5] The first lien debt is currently approximately US$269 million plus accrued interest. There are 22 first lien lenders. RBC is a first lien lender holding approximately 12% of the principal amount outstanding. The first lien debt matured on July 3, 2014. It has not been repaid.

[6] The second lien debt is currently approximately US$153 million plus accrued interest. RBC is a second lien lender, holding the largest share of the principal amounts outstanding, and is the second lien agent for all second lien lenders. The maturity date is July 3, 2015 subject to acceleration.

[7] According to Mr. Greg Nordal, the CEO of Nelson, the business of Nelson has been affected by a general decline in the education markets over the past few years. In the past year,

overall revenues in the K-12 market have declined by 13% and in the higher education market by 3%.

[8] Notwithstanding the industry decline over the past few years, Nelson according to Mr. Nordal has maintained strong EBITDA, which is a credit I am sure to the efforts of Mr. Nordal and the management of Nelson. Nelson's EBITDA has remained positive over the last several years. For the fiscal year ended June 30, 2011 it was $47.4 million, for the fiscal year ended June 30, 2012 it was approximately $37.3 million and for the year ended June 30, 2013 it was approximately $40.9 million.

[9] Mr. Nordal is of the view that Nelson is well positioned to take care of increasing future opportunities in the digital educational market.

[10] Nelson had a leverage ratio of debt to EBITDA of approximately 17:1 for the fiscal year 2015. Its first lien debt matured and has not repaid and it has made no interest payments on the second lien debt since March 31, 2014.

[11] Nelson's efforts to deal with this situation have led to a proposed sale transaction under which the business of Nelson would be sold to the first lien lenders by way of a credit bid and the second lien lenders would be wiped out. In their application requesting an initial order, the applicants proposed a hearing date to be held nine days after the Initial Order to approve this sale transaction. That request was not granted.

[12] In March 2013, Nelson engaged Alvarez and Marsal Canada Securities ULC ("A&M") as its financial advisor to assist the Company in reviewing and considering potential strategic alternatives, including a refinancing and/or restructuring of its credit agreements.

[13] Commencing in April 2013, Nelson, with the assistance of A&M and legal advisors, entered into discussions with a number of stakeholders, including RBC as the second lien agent, the first lien steering committee, and their advisors, in connection with potential alternatives to address Nelson's debt obligations. A number of without prejudice and confidential proposed

transaction term sheets were discussed between August 2013 and September 2014, without any agreement being reached.

[14] During this time, interest continued to be paid on the first lien debt. In March, 2014 Nelson did not paid interest on the second lien debt. In return for a short cure period to May 9, 2014, a partial payment of US$350,000 towards interest was paid on the second lien debt. A further cure period to May 30, 2014 was given on the second lien debt but nothing was paid on it by that date. No further cure period was agreed and no further interest has been paid. Initially during the discussions that took place with the second lien lenders' agent, the professional fees of the advisors to the second lien lenders were paid by Nelson but these were stopped in August, 2014 after there was no agreement regarding further extensions of the second lien debt or agreement on any term sheet.

[15] On September 10, 2014, Nelson announced to the first lien lenders Nelson's proposed transaction framework on the terms set out in the First Lien Term Sheet dated September 10, 2014 (the "First Lien Term Sheet") for a sale or restructuring of the business and sought the support of all of its first lien lenders.

[16] In connection with the First Lien Term Sheet, Nelson entered into a support agreement (the "First Lien Support Agreement") with first lien lenders representing approximately 88% of the principal amounts outstanding under the first lien credit agreement. The consenting first lien lenders comprise 21 of the 22 first lien lenders, the only first lien lender not consenting being RBC. Consent fees of approximately US$12 million have been paid to the consenting first lien lenders.

[17] Pursuant to the terms of the First Lien Term Sheet and the First Lien Support Agreement, Nelson, with the assistance of its financial advisor, A&M, commenced on September 22, 2014, a sale and investment solicitation process (the "SISP") to identify one or more potential purchasers of, or investors in, the Nelson business, which process was conducted over a period of several months. According to Mr. Nordal, Nelson and A&M conducted a thorough canvassing of the market and are satisfied that all alternatives and expressions of interest were properly and thoroughly pursued.

[18] The SISP did not result in an executable transaction acceptable to the first lien lenders holding at least 66 2/3% of the outstanding obligations under the first lien credit agreement. Accordingly, pursuant to the First Lien Support Agreement Nelson wishes to proceed with a transaction pursuant to which the first lien lenders will exchange and release all of the indebtedness owing under the first lien credit agreement for: (i) 100% of the common shares of a newly incorporated entity that will own 100% of the common shares of the purchaser to which substantially all of the Nelson's assets would be transferred, and (ii) the obligations under a new US$200 million first lien term facility to be entered into by the purchaser.

[19] The proposed transaction provides for:

(a) the transfer of substantially all of Nelson's assets to the purchaser;

(b) the assumption by the purchaser of substantially all of Nelson's trade payables, contractual obligations (other than certain obligations in respect of former employees, obligations relating to matters in respect of the second lien credit agreement, and a Nelson promissory note) and employment obligations incurred in the ordinary course and as reflected in the Nelson's balance sheet; and

(c) an offer of employment by the purchaser to all of Nelson's employees.

[20] Under the proposed transaction, with the exception of the obligations owing under the second lien debt and intercompany amounts, substantially all of the liabilities of Nelson are being paid in full in the ordinary course or are otherwise being assumed by the purchaser. The purchaser will not assume Nelson's obligations to the second lien lenders.

[21] On September 10, 2014, pursuant to the First Lien Support Agreement Nelson agreed not to make further payments in connection with the second lien debt, including any payment for fees, costs or expenses to any legal, financial or other advisor to RBC, the second lien agent, without the consent of the consenting first lien lenders.

**Role of A&M Securities**

[22] Nelson engaged A&M, an affiliate of Alvarez & Marsal Canada Inc., as its financial advisor in March, 2013. A&M has been operating as a financial advisor to Nelson for more than two years prior to the date of the Initial Order.

[23] The scope of A&M's engagement in 2013 included the following:

(a) Analyze and evaluate Nelson's financial condition;

(b) Assist Nelson to prepare its 5-year financial model, including balance sheet, income statement and cash flow statement and its 5-year business plan;

(c) Assist Nelson to respond to questions from its lenders regarding Nelson's business plan and financial model;

(d) If requested by management, attend and participate in meetings of the board of directors with respect to matters on which A&M was engaged to advise Nelson; and

(e) Other activities as approved by management or the board of Nelson and agreed to by A&M.

[24] In September 5, 2014 A&M was further engaged to act as the exclusive lead advisor for the transaction that has led to the proposed transaction, including the SISP process undertaken by Nelson. A&M's goal was identified as completing a successful transaction in the most expedient manner. Under this second engagement, A&M's compensation was described as being based on time billed at standard hourly rates and "subject to any other arrangements agreed upon among Nelson, the lenders and A&M". The word "lenders" referred only to the first lien lenders.

[25] In undertaking its mandate under the 2013 and 2014 engagements, A&M was authorized to utilize the services of employees of its affiliates under common control with A&M and subsidiaries. The sample accounts provided by A&M indicate that a substantial number of hours

were billed to the A&M engagement for work of the personnel who are intended to act on behalf of the Monitor in this proceeding. A total of approximately $5.5 million plus HST and disbursements have been billed by A&M for its services to Nelson.

[26] An affiliate of A&M was engaged in 2013 to advise Cengage Learnings, the name of the U.S. operations of Thomson that was changed when Thomson sold its business. The 2013 and 2014 engagements of A&M by Nelson sought Nelson's waiver of any conflict of interest in connection with an A&M affiliate's engagement with Cengage. At the time of the 2013 engagement, A&M U.S. was engaged by Cengage to provide restructuring and financial advisory services and Cengage and Nelson had common shareholders. At the time of the September 2014 engagement, an A&M affiliate was providing financial advisory and financial management services to Cengage. Nelson maintains a strong relationship with Cengage and is the exclusive distributor for Cengage educational content in Canada pursuant to an agreement that expires on January 1, 2018. Cengage also provides certain operational support to Nelson. According to Mr. Nordal, Cengage is a preferred and key business partner of Nelson.

[27] A&M was present at the meetings of Nelson's board of directors wherein the decision was made by that board to not make interest payments to the second lien lenders on March 20, 2014, March 27, 2014, April 7, 2014 and June 27, 2014. A&M was also involved in discussions with RBC and its financial advisors in connection with the extension of the cure period for payment of interest to the second lien lenders as the financial advisor to Nelson.

**Analysis**

[28] In its factum, RBC asserted that the application by Nelson was not an appropriate use of the CCAA as it was intended to be a nine-day proceeding to bless a quick flip credit bid by the first lien lenders to acquire the business of Nelson and extinguish the second lien lenders interest in the assets. RBC however also took the position that it would support a CCAA proceeding on the basis that there would be a neutral Monitor. I must say that in reviewing the circumstances of this application, I can see the issues raised by RBC as to whether this CCAA proceeding was an appropriate use of the CCAA. However in light of the position taken by RBC and my ruling that

A&M Canada should be replaced by FTI as Monitor, I make no further comment or finding on the issue.

[29] This is a true comeback motion with no onus on RBC to establish that A&M Canada should not be the Monitor. Rather the situation is that it is Nelson who is required to establish that A&M Canada is an appropriate monitor.

[30] The problem is that Nelson has proposed a quick court approval of a transaction in which the first lien lenders will acquire the business of Nelson and in which essentially all creditors other than the second lien lenders will be taken care of. Nelson has asserted in its material that the SISP process undertaken by Nelson prior to the CCAA proceedings has established that there is no value in the Nelson business that could give rise to any payout to the second lien lenders. The SISP process was taken on the advice of A&M and under their direction. It was put in Nelson's factum that:

> The Applicants, with the assistance of their advisors, conducted a comprehensive SISP which did not result in an executable transaction that would result in proceeds sufficient to repay the obligations under the First Lien Credit Agreement in full or would otherwise be supported by the First Lien Lenders;

[31] Nelson intends to request Court approval of the proposed transaction. An issue that will be front and centre will be whether the SISP process prior to this CCAA proceeding can be relied on to establish that there is no value in the security of the second lien lenders and whether other steps could have been taken to obtain financing to assist Nelson in continuing in business other than a credit bid by the first lien lenders. A&M was centrally involved in that process. It is in no position to be providing impartial advice to the Court on the central issue before the Court.

[32] There is no suggestion that A&M are not professional or not aware of their responsibilities to act independently in the role of a monitor. A&M is frequently involved in CCAA matters and is understandably proud of its high standard of professionalism. However, that is not the issue. In my view, A&M should not be put in the position of being required to step back and give advice to the Court on the essential issue before the Court in light of its central role in the whole process that will be considered.

[33] In an article in the Commercial Insolvency Reporter, (LexisNexis, August 2010), entitled *Musings (a.k.a. Ravings) about the Present Culture of Restructurings,* former Justice James Farley, the doyen of the Commercial List for many years and no stranger to CCAA proceedings, had this to say about the role of a monitor:

> I mean absolutely no disrespect or negative criticism towards any monitor when I observe that they are only human. I think it is time to consider whether a monitor can truly be objective and neutral under present circumstances- it would take a true saint to stand firm under the pressures now prevailing. It should be appreciated that monitors are in fact hired by the debtor applicant (aided by perhaps a party providing interim financing, possibly in the role of the power behind the throne) and retained to advise the debtor well before the application is made. Is it not human nature for a monitor to subconsciously wonder where the next appointment will come from if it crosses swords with its hirer?

[34] Mr. Farley went on to suggest that the role of a monitor be split in two. That may be a laudable objective, but would require legislation. In this case, I do not think it would be appropriate in light of the extremely extensive work done by A&M over the course of two years.

[35] A monitor is an officer of the Court with fiduciary duties to all stakeholders and is required to assist the Court as requested. It has often been said that a monitor is the eyes and ears of the Court. It is critical that in this role a monitor be independent of the parties and be seen to be independent. I can put it no better than Justice Topolniski in *Winalta Inc. (Re),* 2011 ABQB 399 in which she said:

> **67** A monitor appointed under the *CCAA* is an officer of the court who is required to perform the obligations mandated by the court and under the common law. A monitor owes a fiduciary duty to the stakeholders; is required to account to the court; is to act independently; and must treat all parties reasonably and fairly, including creditors, the debtor and its shareholders.
>
> **68** Kevin P. McElcheran describes the monitor's role in the following terms in *Commercial Insolvency in Canada* (Markham, Ont.: LexisNexis Butterworths, 2005) at p. 236:
>
> > The monitor is an officer of the court. It is the court's eyes and ears with a mandate to assist the court in its supervisory role. The monitor is not an advocate for the debtor company or any party in the *CCAA* process. It has

> a duty to evaluate the activities of the debtor company and comment independently on such actions in any report to the court and the creditors.

[36] In this case, A&M is in no position to comment independently on the activities of Nelson in regards to the very issue in this case, namely the reliability of the SISP program in determining whether the second lien lenders' security has any value.

[37] There is also a question of the appearance of a lack of impartiality. During the two years that A&M was engaged prior to this CCAA proceeding, for which it billed over $5 million, it was involved in advising Nelson during negotiations with the interested parties, including RBC, and in participating in those negotiations with RBC on behalf of Nelson. This history can cause an appearance of impartiality, something to be avoided in order to provide public confidence that the insolvency system is impartial. See *Winalta* at para. 82. It was this concern of a perception of bias that led to the prohibition being added to section 11.7(2) of the CCAA preventing an auditor of a company acting as a monitor of the company.

[38] The issue of an appropriate monitor requires the balancing of interests. This is not like some cases in which a financial advisor has had some advisory role with the debtor and then becomes a monitor, usually with no objection being raised. Often it may be appropriate for that to occur taken the knowledge of the debtor acquired by the advisor. This case is different in that the financial advisor has been front row and centre in the very sales process that will be the subject of debate in these proceedings and has engaged in negotiations on behalf of Nelson.

[39] In all of the circumstances of this case, I concluded that it would be preferable for another monitor to be appointed and for that reason replaced A&M Canada as Monitor with FTI.

**Other issues**

[40] In the Initial Order, RBC was directed to continue its cash management system. There was no charge provided in favour of RBC. RBC says that it should not be required to continue the cash management system without the protection of a charge. During this hearing, Mr. Chadwick on behalf of Nelson said that it might be possible to satisfy RBC by requiring some

minimum balance in the accounts, failing which a charge would be provided in favour of RBC. I take it that this issue will be worked out.

[41] In the draft Initial Order that accompanied the CCAA application at the outset, a paragraph was included that provided that Nelson could not pay any amounts owing by Nelson to its creditors except in respect of interest, expenses and fees, including consent fees, payable to the first lien lenders and fees and expenses payable to the first lien agent under the support agreement. That provision was deleted from the Initial Order. It was replaced with a provision that Nelson could pay expenses and satisfy obligations in the ordinary course of business.

[42] RBC takes the position that there should be a level playing field for the second lien lenders consistent with the treatment of the first lien lenders in this CCAA process, and that if interest is to be paid to the first lien lenders and expenses of their financial and legal advisors paid, the same should happen to the second lien lenders.

[43] RBC points out that it was Nelson who decided in June, 2014 to stop paying interest on the second lien debt and a little later reduce paying RBC's advisors in light of Nelson's view that there was not sufficient progress in negotiations with RBC. Payment of these professional fees was stopped in August, 2014. In September 2014 Nelson agreed in the First Lien Support Agreement not to make further payments in connection with the second lien debt, including any payment for fees, costs or expenses to any legal, financial or other advisor to RBC, the second lien agent, without the consent of the consenting first lien lenders. The consenting first lien lenders are opposed to any interest or expenses being paid to the second lien lenders.

[44] The second lien credit agreement provides for interest to be paid on the debt and in section 10.03 for all costs of the second lien agent, RBC, arising out of CCAA proceedings. The intercreditor agreement between the first and second lien agents provides in section 3.1(f) that nothing in the agreement save section 4 shall prevent receipt by the second lien agent payments for interest, principal and other amounts owed on the second lien debt. Section 4 provides that any collateral or proceeds of sale of the collateral shall be paid to the first lien agent until the first lien debt has been repaid and then to the second lien agent. As there has been no sale of the collateral, there is nothing in the intercreditor agreement that prevents payment of interest and

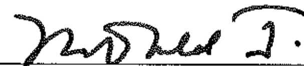
expenses of the second lien lenders. The second lien lenders are contractually entitled to receive payment of their interest, costs, expenses and professional fees.

[45] No determination has been made in these proceedings that there is no value available for the second lien lenders. RBC disputes the applicants' views on this point. RBC contends that these CCAA proceedings should not commence with the Court accepting as a *fait accompli* that the second lien lenders should not be paid in the proceeding when every other stakeholder is being paid.

[46] There is no evidence that Nelson has not been in a position to pay the interest, costs, expenses and professional fees of the second lien lenders since it made a decision in 2014 to stop paying these amounts. Since the First Lien Support Agreement with the consenting first lien lenders, the decision has been taken out of the hands of Nelson and turned over to the consenting first lien lenders.

[47] In my view, on the basis of the evidence, there is no justification to pay all of the interest, costs and expenses of the first lien lenders but not pay the same to the second lien lenders. In the circumstances, it is only fair that pending further order, Nelson be prevented from paying any interest or other expenses to the first lien lenders unless the same payments owing to the second lien lenders are made, and it is so ordered.

[48] RBC has requested costs of the comeback motion and I believe other costs. A request for costs may be made in writing by RBC within 10 days, along with a proper cost outline, and the parties against whom costs are claimed shall have 10 days to file a response to the cost request.



Newbould J.

**Date:** June 2, 2015

# TAB 2

# Report of the Model First Lien/Second Lien Intercreditor Agreement Task Force

*By the Committee on Commercial Finance, ABA Section of Business Law**

This is the Report of the Model First Lien/Second Lien Intercreditor Agreement Task Force ("Task Force") established by the Commercial Finance Committee of the Business Law Section of the American Bar Association. This Report will first review the reasons for the creation of the Task Force, its goals, and its methodology. It will then introduce and examine each major provision of the Model Agreement, exploring its purpose, perceived market practice, and the perspectives of first and second lien creditors. Where appropriate, the Report will present alternative provisions and views.

## Creation of the Task Force

Intercreditor agreements are used in a variety of financing transactions to establish the respective rights and remedies of two or more creditors in credit facilities provided to a common borrower. Intercreditor agreements are not standardized, and their scope varies widely. Intercreditor agreements may include payment subordination provisions, payment standstill terms, and other creditor rights and remedies that do not involve collateral. Such payment subordination arrangements are typically found in unsecured mezzanine financing, for example. In secured financing transactions, however, the intercreditor agreement may also govern the relative rights and priorities of each creditor's liens in the borrower's assets, and it is here that the Task Force has concentrated its efforts.

The past five to eight years have witnessed an increase in the use of "second lien" structures in institutional senior secured syndicated financing transactions. These structures involve a "first lien" loan secured by a first priority lien in substantially all of the assets of the borrower, and a separate pari passu "second lien" loan, typically provided by a separate lender group, secured by a second priority lien in the same collateral. Second lien structures have enjoyed increased popularity in recent years because of the increased liquidity provided by second lien lenders that might not have provided financing on an unsecured basis, and because of the relatively narrow interest rate spreads available in the second lien market before the financial crisis in the latter half of 2008.

* As of March 22, 2010.



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Until the financial crisis, the second lien market had grown rapidly. According to the Loan Pricing Corporation, the dollar volume of second lien loans grew from approximately $8 billion in 2003 to over $29 billion in 2006.[1] In the second quarter of 2007, second lien loans reached $15.21 billion, the highest quarter recorded for second lien issuance.[2] Like other forms of leveraged finance, second lien financing fell sharply with the 2008 credit crisis. By the second quarter of 2009, second lien issuance was under $300 million.[3]

Second lien structures also migrated to the middle market, and to asset-based loans, where second lien structures became common. A typical structure is for a revolving lender to hold a first lien in all accounts, inventory, and other current assets while a term lender holds a first lien in equipment, real estate, and other fixed assets, with each lender also holding a second lien in the other's primary collateral. Variations of such "wrap" structures have become increasingly creative.

As the second lien market grew, counsel to first lien lenders drafted various forms of substantially similar first lien/second lien intercreditor agreements. In the early years of the second lien market, the second lien lender generally subordinated virtually all of its rights as a secured creditor to the rights of the first lien creditor until the first lien creditor was paid in full—a so-called "silent second." Surprisingly, there was little published guidance on the issues that counsel should consider in drafting or reviewing an intercreditor agreement, and participants relied heavily on "market practice." It gradually became apparent, however, that the market had only a limited experience of the effect of these provisions following a default by the borrower or the initiation of a bankruptcy proceeding.

Although second lien transactions are structured in myriad ways, the principal intercreditor issues remain consistent throughout all structures. Similar intercreditor issues arise in most other secured transactions involving lien subordination. Therefore, the Task Force believes that the development of a form of first lien/second lien intercreditor agreement that covers the major recurring issues and fairly protects the interests of first and second lien creditors while reflecting market expectations would be a useful resource for practitioners.

## Principal Goals and Use of Model Agreement

It is important to identify what the Model Agreement is not. The Task Force initially received the criticism that its work would be of limited utility because an intercreditor agreement could not be standardized for all transactions. Although this is a legitimate concern, it is important to note that nearly all intercreditor agreements dealing with priority of liens in common collateral must necessarily address similar lien subordination issues. Likewise, all must address the effect of the intercreditor terms both outside of bankruptcy and during the pendency of a

1. LoanConnector, www.loanconnector.com (downloaded Apr. 1, 2010).
2. *Id.*
3. *Id.*

bankruptcy proceeding. While there will be structural differences in the transaction itself, the same issues will be present.

The Model Agreement and accompanying comments, other footnotes, and text are intended, first and foremost, to be a reference tool for the practitioner. The comments are intended to explain the general purpose of each section, highlight the principal issues encountered in practice, and convey the prevailing market expectation. Accordingly, the Model Agreement is not a universal solution to the problem of identifying the "correct form" to use for a transaction. The form will necessarily be determined by the details of the transaction. The Model Agreement introduces the major components of lien intercreditor agreements generally, addresses why such provisions are necessary, and explores the effect of drafting a provision in a manner more favorable to a first or second lien lender. Armed with an understanding of these basic concepts and their implementation in the Model Agreement, the practitioner may construct an intercreditor agreement that fits his or her transaction.

The Model Agreement does not address all types of transactions. For example, an intercreditor agreement for an asset-based transaction would typically include a provision requiring the holder of a first lien in fixed assets in a wrap structure to allow the holder of the first lien in the current assets to remain on the real property for a certain period of time to use the fixed assets to complete manufacture of goods to provide finished product for pending orders. Increasingly, lien intercreditor agreements also deal with payment subordination provisions and rights of additional secured parties such as third and fourth lienholders on common collateral. These variations are beyond the scope of the Model Agreement.

## How the Task Force Conducted Its Work

The Task Force is sponsored by the Syndications and Lender Relations Subcommittee of the Commercial Finance Committee of the Section of Business Law of the American Bar Association. The Chair of the Task Force is Gary D. Chamblee. The Vice Chairs of the Task Force are Alyson Allen, Christian Brose, Richard K. Brown, Robert L. Cunningham, Jr., Randall Klein, and Jane Summers, and the Editor is Howard Darmstadter. In addition to the Chair and the Vice Chairs, other members of the Task Force have played key roles in drafting the text and commentary of the Model Agreement, including Anthony R. Callobre, John Francis Hilson, and Matthew W. Kavanaugh. Many other members of the Task Force regularly attended meetings of the Task Force, contributed significantly to the ongoing discussion regarding the many difficult issues faced by the Task Force, and otherwise made contributions essential to the goal of providing a balanced, market-driven Model Agreement. The names of the over 200 members of the Task Force and their law firms or other affiliations can be found on the Task Force web site at http://www.abanet.org/dch/committee.cfm?com=CL190029.

The Task Force was formed in the spring of 2006 and met for the first time at the 2006 Annual Meeting in Honolulu, Hawaii. The Task Force is composed of practitioners who represent primarily first lien lenders, practitioners who represent

primarily second lien lenders, and practitioners who represent both. As a result, the Task Force reflected a relatively balanced representation among all concerned parties. At the initial meeting, it was determined that the Task Force would meet at each scheduled meeting of the Section, which includes the Spring Meeting in April, the Annual Meeting in August, and the Fall Meeting in November of each year, and would also meet by telephone conference on a regular basis.

The agreement selected by the Task Force as a source document is an institutional first lien/second lien intercreditor agreement commonly used in the market for second lien transactions initially prepared by Latham & Watkins LLP. This form was disassembled by subject matter sections, with each section being the focus of one or more of the Task Force meetings. Where possible, the Task Force utilized experts in certain practice areas among its members to lead the review and revision of the respective sections in the member's specialty. After each Task Force meeting, the Model Agreement was revised to reflect the concerns raised by Task Force members at the meeting.

Significant discussion was devoted to the presentation of alternative provisions favoring second lien lenders. Task Force members who represented primarily second lien lenders were troubled by the placement of such provisions as footnotes or at the end of the agreement, feeling that such placement implied that the alternative text did not reflect market terms. It was decided that alternative text that involved concepts important to second lien lenders and that was actually used in practice would be placed in the body of the relevant section of the agreement as a second lien favorable alternative. Concepts deemed less important or not widely used in practice, as well as clarifications and explanations of differences and concerns of the various parties, would be placed in the footnotes. In addition, introductory comments are included in notes to most sections of the Model Agreement.

Following the initial revision of each section, the Model Agreement was further edited and revised stylistically by Howard Darmstadter. The Task Force is grateful for Howard's fine work in making the Model Agreement more concise and user friendly.

The Task Force intends from time to time to publish appendices or revisions to the Model Agreement to deal with special situations or to reflect the experience of practitioners working with the document and to reflect market changes.

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# First Lien/Second Lien Intercreditor Agreement

*[First Lien Agent]*
*[Second Lien Agent]*
*[Control Agent]*
*[Borrower]*
*[Holdings]*
*[Guarantor Subsidiaries]*
*[date]*

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(3) any conflicting provision of the U.C.C. or other applicable law,
(4) the modification of a First Lien Obligation or a Second Lien Obligation,
(5) the modification of a First Lien Loan Document or a Second Lien Loan Document,
(6) the subordination of a Lien on Collateral securing a First Lien Obligation to a Lien securing another obligation of a Grantor or other Person that is permitted under the First Lien Loan Documents as in effect on the date hereof or secures a DIP Financing deemed consented to by the Second Lien Claimholders pursuant to Section 6.1, "*Use of Collateral and DIP Financing*,"
(7) the exchange of a security interest in any Collateral for a security interest in other Collateral, or
(8) the commencement of an Insolvency Proceeding.]

[END OF ALTERNATIVE SECTION]

### 1.2 NO PAYMENT SUBORDINATION[8]

The subordination of Liens securing Second Lien Obligations to Liens securing First Lien Obligations set forth in the preceding section 1.1 affects only the relative priority of those Liens, and does not subordinate the Second Lien Obligations in right of payment to the First Lien Obligations. Nothing in this Agreement will affect the entitlement of any Second Lien Claimholder to receive and retain required payments of interest, principal, and other amounts in respect of a Second Lien Obligation unless the receipt is expressly prohibited by, or results from the Second Lien Claimholder's breach of, this Agreement.

### 1.3 FIRST LIEN OBLIGATIONS AND SECOND LIEN OBLIGATIONS

(a) ***First Lien Obligations*** means all Obligations of the Grantors under
(1) the First Lien Credit Agreement and the other First Lien Loan Documents,
(2) the guaranties by Holdings and the Guarantor Subsidiaries of the Borrower's Obligations under the First Lien Loan Documents,
(3) any Hedge Agreement entered into with an agent or a lender (or an Affiliate thereof) under the First Lien Credit Agreement (even if the counterparty or an Affiliate of the counterparty ceases to be an agent or a lender under the First Lien Credit Agreement),
(4) any Cash Management Agreement, or
(5) any other agreement or instrument granting or providing for the perfection of a Lien securing any of the foregoing.

Notwithstanding any other provision hereof, the term "First Lien Obligations" will include accrued interest, fees, costs, and other charges incurred

8. The typical second lien financing intercreditor agreement does not require payment subordination.

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## 2 Modification of Obligations[26]

### 2.1 Permitted Modifications[27]

Except as otherwise expressly provided in this section 2,

(a) the First Lien Obligations may be modified in accordance with their terms, and their aggregate amount increased or Refinanced, without notice to or consent by any Second Lien Claimholder, *provided* that the holders of any Refinancing Indebtedness (or their agent) bind themselves in a writing addressed to Second Lien Claimholders to the terms of this Agreement, and

(b) the Second Lien Obligations may be modified in accordance with their terms, and their aggregate amount increased or Refinanced, without notice to or consent by any First Lien Claimholder, *provided* that the holders of any Refinancing Indebtedness (or their agent) bind themselves in a writing addressed to First Lien Claimholders to the terms of this Agreement.

---

26. The modification provisions are intended to balance the desire of each class of creditor to administer freely its loan documents and refinance the debt thereunder against the interest of the other class of creditor in protecting against any modification or refinancing that alters any fundamental assumption about the borrower's capital structure relied on in underwriting the transaction. Fundamental issues usually addressed in the modification provisions include prohibitions on:

i) increasing the maximum permitted advances of first lien/second lien obligations above negotiated caps;
ii) extension of the maturity of the first lien obligations beyond the maturity date of the second lien obligations;
iii) accelerating the amortization/maturity of the second lien obligations or increasing any mandatory prepayment obligations; and
iv) increasing interest rates above specified levels.

Additional restrictions may or may not appear in the intercreditor agreement or in the first lien loan documents or second lien loan documents.

The scope of restrictions on amendments is highly negotiated and varies depending on the market in question. While first lien and second lien claimholders will usually object to the borrower or its counsel becoming deeply involved in negotiating the terms of the intercreditor agreement, the borrower will be highly motivated to scrutinize the modification restrictions and the debt cap definitions. The borrower's interests will be aligned with those of the first lien claimholders as these provisions greatly impact the future flexibility of the borrower to incur additional debt, refinance existing debt on market terms, and obtain covenant relief.

27. The Model Agreement starts with the baseline concept that the first lien claimholders and second lien claimholders are generally free to amend their respective loan documents and refinance the obligations thereunder subject to meeting a limited set of parameters. This concept respects the status of the second lien obligations as debt that is senior in priority of payment and may be contrasted with the approach generally taken with respect to mezzanine or other payment subordinated obligations. Payment subordinated obligations are most often subject to broad restrictions on amendments and other modifications and will almost always prohibit any prepayment or refinancing of the subordinated obligations until the senior obligations are paid in full. While the Model Agreement focuses primarily on the economic terms of the obligations and does not prohibit the first and second lien claimholders from tightening or adding covenants or events of default, such amendments are usually prohibited by covenants in the first lien credit agreement in order to preserve any negotiated covenant cushion existing at the outset of the transaction. Likewise, cross-default provisions in the second lien loan documents should be reviewed and qualified as necessary to preserve any such negotiated covenant cushion.

However, no such modification may alter or otherwise affect sections 1.1, "*Seniority of Liens Securing First Lien Obligations*," or 1.8, "*Prohibition on Contesting Liens; No Marshaling*."

## 2.2 Modifications Requiring Consent[28]

Notwithstanding the preceding section 2.1, [and except as otherwise permitted as DIP Financing provided by the First Lien Lenders and deemed consented to by the Second Lien Lenders pursuant to section 6.1, "*Use of Cash Collateral and DIP Financing*,"] Second Lien Agent must consent to any modification to or Refinancing of the First Lien Obligations, and First Lien Agent must consent to any modification to or Refinancing of the Second Lien Obligations, that:

(a) increases the aggregate principal amount of loans, letters of credit, bankers acceptances, bonds, debentures, notes, or similar instruments or other similar extensions of credit [(but excluding obligations under Hedge Agreements or Cash Management Agreements) [and, for Second Lien Obligations, any increase resulting from payment of interest in kind permitted under the Second Lien Credit Agreement as in effect on the date hereof]] or commitments therefor beyond

   (1) for the First Lien Obligations, the amount permitted by the First Lien Cap, or[29]

   (2) for the Second Lien Obligations, the [amount theretofore permitted under the First Lien Credit Agreement][the amount permitted by the Second Lien Cap];

28. The "laundry list" approach set forth in the Model Agreement is frequently encountered in middle-market transactions. Larger syndicated loan transaction and bond second lien deals often have fewer restrictions on the modification or refinancing of the first lien obligations. The restrictions in this section may also be largely addressed in the applicable loan documents rather than in the intercreditor agreement. As discussed above, restrictions on any modification or refinancing must be carefully considered relative to the definitions used to formulate any debt caps. See also note 12 above concerning potential restrictions on amendments that reallocate portions of term facility exposure to revolving exposure in cases where the second lien claimholders are seeking to require a minimum amount of amortization. While it is a case involving payment subordinated obligations, a worst-case scenario for a second lien claimholder (or a best-case scenario for a first lien claimholder) concerning flexibility to modify a class of debt with senior lien priority is illustrated by *In Re Musicland Holding Corp.*, 374 B.R. 113 (Bankr. S.D.N.Y. 2007). In that case, a senior revolving credit facility was successfully modified pursuant to the terms of a broadly drafted intercreditor agreement to incorporate an additional term loan facility that "leapfrogged" the subordinated creditors in the priority of distribution of the debtor's Chapter 11 estate. *Id.* at 118–19.

The amount of any permitted percentage increase in the interest rate is among the items subject to negotiation between the parties. A maximum 2 percent per annum increase has been a common agreed upon amount; however, this negotiated amount is being revisited by many in the aftermath of the recent market disruption and widespread re-pricing of transaction exposure. The alternative text with respect to asset-based lending transactions is often strongly resisted. To the extent that such alternative text is included, the first lien claimholders should consider whether sufficient flexibility to make protective advances or over-advances generally is included in the first lien loan documents or needs to be expressly addressed in the intercreditor agreement.

29. Consider whether subordination of excess first lien obligations is a sufficient remedy, or whether the agreement should also include an outright prohibition on extensions of credit in excess of the cap.

### 3.3 Specific Performance[39]

First Lien Agent and Second Lien Agent may each demand specific performance of this Agreement, and each waives any defense based on the adequacy of a remedy at law and any other defense that might be asserted to bar the remedy of specific performance in any action brought by a Second Lien Claimholder or a First Lien Claimholder, respectively.

### 3.4 Notice of Exercise[40]

The First and Second Lien Agents will each provide reasonable prior notice to the other of its initial material Enforcement Action.

## 4 Payments

### 4.1 Application of Proceeds[41]

Until the Discharge of First Lien Obligations and the Discharge of Second Lien Obligations, and regardless of whether an Insolvency Proceeding has been com-

39. The Model Agreement recognizes that the right to bring an enforcement action or prevent an unauthorized enforcement action is an essential right for which the parties have specifically bargained under the Model Agreement. Accordingly, the Model Agreement grants each party the right to demand specific performance under the Agreement, and each party waives the right to assert the adequacy of a remedy at law or any other defense that might be asserted to bar the remedy of specific performance.

40. First lien claimholders and second lien claimholders have a common interest in the collateral and a common desire to ensure that enforcement actions are conducted in a manner that will yield the maximum possible proceeds for application to the first lien obligations and the second lien obligations. Accordingly, both first lien claimholders and second lien claimholders agree to give each other notice of their commencement of an initial material enforcement action.

41. As has been detailed earlier, among the primary benefits to the first lien claimholders of the Model Agreement are the priority of their liens over those of the second lien claimholders and the enforcement priority that they enjoy relative to their liens. *See* note 33 to section 3. The enforcement priority is effectuated by the standstill period, which provides the first lien claimholders a "head start" relative to enforcement of their liens. The Model Agreement also continues the exclusivity relative to lien enforcement if, prior to the expiration of the standstill period or prior to the permitted commencement of lien enforcement by the second lien claimholders, as applicable, the first lien claimholders have commenced and thereafter are diligently pursuing the exercise of their rights or remedies with respect to all or any material portion of the collateral. As a corollary to the exclusive enforcement remedies, this section provides for the application of proceeds received in connection with an enforcement action. Commonly referred to as a "waterfall" provision, the section expressly provides that it is applicable before or after the commencement of an insolvency proceeding. It should be noted, however, that this section does not apply to payments or other distributions made in an insolvency proceeding unless those payments or other distributions are received in connection with an enforcement action. It should also be noted that the section is applicable to collateral or proceeds received in connection with an enforcement action irrespective of whether the action was taken by the first lien claimholders or the second lien claimholders. In the unlikely event that the first lien claimholders have allowed the standstill period to expire and the second lien claimholders exercise their rights to take enforcement actions, this section still requires that the proceeds of such exercise be run through the waterfall. While, as to collateral that is subject to Article 9, this would appear to conflict with section 9-615(a) of the U.C.C., section 9-615(a) is not one of the sections of the U.C.C. that section 9-602 expressly states cannot be waived or varied by the debtor. Presumably, the execution of the Model Agreement by the various grantors would be deemed to be a waiver of the provisions of section 9-615(a) when the proceeds result from an enforcement action taken by the second lien claimholders. The waterfall provision

menced, Collateral or Proceeds received in connection with an Enforcement Action or subject to section 6.7, "*Reorganization Securities*," received in connection with any Insolvency Proceeding involving a Grantor will be applied

(a) ***first***, to the payment in full or cash collateralization of all First Lien Obligations that are not Excess First Lien Obligations,
(b) ***second***, to the payment in full of the Second Lien Obligations [that are not Excess Second Lien Obligations],
(c) ***third***, to the payment in full of any Excess First Lien Obligations[,
(d) ***fourth,*** to the payment in full of any Excess Second Lien Obligations],[42] and
(e) ***fifth,*** to the applicable Grantor or as otherwise required by applicable law.

in each case as specified in the First Lien Documents or the Second Lien Documents, or as otherwise determined by the First Lien Claimholders or the Second Lien Claimholders, as applicable.

[Notwithstanding the foregoing, until the Discharge of First Lien Obligations up to the First Lien Cap with respect to First Lien Obligations that are capped Obligations and in their entirety with respect to First Lien Obligations that are not Capped Obligations, any non-cash Collateral or non-cash Proceeds will be held by First Lien Agent as Collateral unless the failure to apply such amounts as set forth above would be commercially unreasonable.[43]]

establishes a priority of application of the proceeds of the collateral, first to the first lien obligations (up to the amount of the first lien cap), second to the second lien obligations (up to the amount of any second lien cap), third to the excess first lien obligations (i.e., the amount of the obligations owing under the first lien loan documents in excess of the first lien cap), and fourth to the excess second lien obligations (i.e., the amount of the obligations owing under the second lien loan documents in excess of a second lien cap). In each case, the application within a particular tier is as specified in the applicable loan documents. Presumably, the loan documents will contain their own order of application of payments, including applying collateral proceeds to the costs and expenses of enforcement, to accrued and unpaid interest, and to the outstanding principal balance of the loans. When combined with the other provisions of the Model Agreement, this section completes a trifecta, i.e., the liens of the first lien claimholders have priority, the enforcement rights of the first lien claimholders have priority, and the first lien claimholders have priority as to the application of the proceeds of any enforcement action. The section does not distinguish between cash proceeds and non-cash proceeds, but should be interpreted to require the application of cash proceeds to the applicable obligations as and when received and to defer the application of the non-cash proceeds to the applicable obligations until such non-cash proceeds have been monetized.

42. Some intercreditor agreements do not address the consequences of the first lien lender exceeding the first lien cap or the second lien lender exceeding a second lien cap. In the absence of an agreement between the parties as to the effect of the first lien lender exceeding the first lien cap, the second lien lender might argue that the breach by the first lien lender of the intercreditor agreement should preclude it from enforcing the agreement. One alternative for addressing this issue is to provide in the intercreditor agreement that excess first lien obligations (i.e., obligations in excess of the first lien cap) will be given a priority immediately after the second lien obligations. This "waterfall' may be implemented without formally classifying the excess amount as "subordinated debt," as such classification of a portion of the first lien obligations as "third lien" or "subordinated" may run afoul of the terms of the first lien lender's credit approval. *See* section 1.11.

43. *See* U.C.C. § 9-615(c) (2008).

# TAB 3

2014 WL 4436335
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United States Bankruptcy Court, S.D. New York.

In re: MPM Silicones, LLC, et al., Debtors.

Case No. 14-22503-rdd | Signed September 9, 2014

**Attorneys and Law Firms**

Willkie Farr & Gallagher, LLP Attorneys for Debtors 787 Seventh Avenue New York, NY 10019 By: Matthew A. Feldman, Esq.

United States Department of Justice Office of the United States Trustee 210 Varick Street Room 1006 New York, NY 10014 By: Brian S. Masumoto, Esq. (Telephonically)

Milbank, Tweed, Hadley & McCloy LLP Attorneys for Ad Hoc Committee of Second Lien Holders One Chase Manhattan Plaza New York, NY 10005 By: Dennis F. Dunne, Esq.

Milbank, Tweed, Hadley & McCloy LLP Attorneys for Ad Hoc Committee of Second Lien Holders 1850 K Street, NW Washington, DC 20006 By: Andrew M. Leblanc, Esq.

Quinn Emanuel Urquhart & Sullivan, LLP Attorneys for U.S. Bank, N.A. 51 Madison Avenue 22nd Floor New York, NY 10010 By: Susheel Kirpalani, Esq.

Ropes & Gray LLP Attorneys for Wilmington Trust, Trustee of 1.5 Notes 1211 Avenue of the Americas New York, NY 10036 By: Mark I. Bane, Esq.

Akin Gump Strauss Hauer & Feld LLP Attorneys for Apollo One Bryant Park New York, NY 10036 By: Abid Qureshi, Esq. Philip C. Dublin, Esq. Ira S. Dizengoff, Esq.

Irell & Manella LLP Attorneys for Bank of New York Mellon Trust Company 1800 Avenue of the Stars Suite 900 Los Angeles, CA 90067 By: Jeffrey Reisner, Esq. (Telephonically) Alan J. Friedman, Esq. (Telephonically)

Dechert LLP Attorneys for First Lien Trustee 1095 Avenue of the Americas New York, NY 10036 By: Michael J. Sage, Esq.

**Chapter 11**

**Corrected and Modified Bench Ruling on Confirmation of Debtors' Joint Chapter Plan of Reorganization for Momentive Performance Materials Inc. and its Affiliated Debtors.**

BEFORE: HON. ROBERT D. DRAIN U.S. BANKRUPTCY JUDGE

***1** Good afternoon. We are back on the record in In re MPM Silicones, LLC. I had adjourned my bench ruling on confirmation of the debtors' chapter 11 plan and the related rulings in the three adversary proceedings to give the parties another day to see if they could negotiate, as between the first and the 1.5 lien holders and the debtors and the second lien holders' representatives, any settlement of their issues. I gather, since you're all here and looking fairly stony faced, that hasn't happened?

Okay. All right. So, I will give you my ruling on confirmation.

I am going to give what will sound like a series of bench rulings on five issues that remain open regarding confirmation of the chapter 11 plan and, with respect to the subordination of the senior subordinated unsecured notes, or the extent of that subordination, and the extent of the so-called make-whole provisions in the first and 1.5 lien indentures, in the three related adversary proceedings covered by my prior order on confirmation hearing procedures. The context of each of these rulings, however, is my ruling on confirmation of the debtors' chapter 11 plan, as it has been modified on the record a couple of times during the confirmation hearing.

I have reviewed all of the evidence submitted in connection with the debtors' request for confirmation of the plan, which includes not only the live trial record of the four-day confirmation hearing held last week, but also the declarations, exhibits, including expert reports, and deposition testimony that was admitted into evidence during that time. It's clear to me that, except for the issues that I am about to rule on and the one other issue that I ruled on last week, namely, the absolute priority rule objection to confirmation of the plan raised by the subordinated noteholders, which I decided in favor of the debtors, there are no disputes as to the confirmation of the plan. And, having reviewed the record, I am prepared to make the findings under section 1129(a) of the Bankruptcy Code required for confirmation, leaving aside, again, the five issues that I am going to address this afternoon.

I clearly have jurisdiction with regard to those issues, which arise under sections 510(a), 502(b)(2), 506(b), 1129(a) and (b) of the Bankruptcy Code, pursuant to 28 U.S.C. sections 157(a)-(b) and 1334(b), as these issues arise under the Bankruptcy Code and in the chapter 11 case, let alone that they're clearly related to the chapter 11 case.

As I noted, two of the issues also arise in three adversary proceedings, and at least one of the parties in those proceedings has stated, as required under the Local Rules, its view that the Court lacks the power to issue a final order or final determination of the issues in that proceeding. Absent the Supreme Court's ruling in Stern v. Marshall, 131 S.Ct. 2594 (2011), there would be no question that I have such power, as these are all core matters under 28 U.S.C. section 157(b)(2), each pertaining to confirmation of the debtors' plan and/or the treatment of the claims of the first lien holders, 1.5 lien holders, second lien holders and subordinated noteholders.

***2** I continue to have the power to issue a final order on these issues on a Constitutional basis under Stern v. Marshall. The issues all involve fundamental aspects of the adjustment of the debtor/creditor relationship. Colloquially, they pertain to how the pie of the bankruptcy estate will be divided among the groups of claimants that I just listed, not whether the estate will be augmented by a claim against a third party. Moreover, the issues clearly pertain to rights unique to bankruptcy law under section 1129(b) of the Bankruptcy Code and sections 1129(a)(1) and 510(a) of the Code, as well as the treatment of claims under sections 502(b)(2) and 506(b) of the Code. Accordingly, under Stern v. Marshall, 131 S.Ct. 2618, I have the power to issue a final order or determination on these issues notwithstanding that this is an Article I, not an Article III, court.

These rulings, as will ultimately be memorialized in an order on confirmation as well as orders in respect of the three adversary proceedings, in each case will be a final determination by the Court.

Before I get to the rulings, I also want to note that I am providing a bench ruling here in recognition of the need for a prompt determination in this case of these issues, after having established a complete record and thought about them, I hope, thoroughly. These are ongoing businesses with thousands of employees as well as hundreds if not thousands of creditors and customers, and they deserve a prompt response. As I noted yesterday, when I give a bench ruling, at times the ruling can be lengthy with significant citation; and in those instances I normally go over the transcript and reserve the right to correct it not only as to inaccuracies by the court reporter, but also as to content, whether I said something ungrammatically, for example, or whether I wanted to say something slightly differently. If I do edit the ruling on the latter two grounds, I will separately file it as a modified bench ruling. It won't be the transcript at that point; it will instead be a modified bench ruling, although the holdings on these issues won't change.

Let me turn to the first issue, which involves, as noted, the extent of the subordination of the senior subordinated unsecured notes. This issue comes up in Adversary Proceeding No. 14–08238 under section 510(a) of the Bankruptcy Code, which provides, “A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law.” It is also integral to the Court's consideration of the debtors' request for confirmation of the chapter 11 plan, because the plan has a specific interpretation of the extent of the subordination of the senior subordinated notes that the subordinated noteholders disagree with and provides, based on that interpretation, that there will be no distribution to the senior subordinated noteholders in recognition of the debtors' view, supported by the second lien holders, that their subordination agreement requires that any distribution that would otherwise go to them would have to be distributed instead to the second lien holders in full.

It thus serves as a gate-keeping issue for confirmation of the plan, because section 1129(a)(1) of the Bankruptcy Code provides that, to be confirmed, the plan must comply with the applicable provisions of the Code, which include section 510(a).

The outcome hinges primarily if not entirely on interpretation of the relevant agreement, the senior subordinated unsecured note indenture, which, as all of the parties recognize, is governed by New York law. They also recognize that, when interpreting the indenture, the Court should apply basic New York contract law. See In re AMR Corp., 730 F.3d, 88, 98 (2d Cir.2013), citing, among other cases, Sharon Steel Corp. v. Chase Manhattan Bank N.A., 691 F.2d 1039, 1049 (2d Cir.1982).

***3** Those basic contract interpretation principles are well established. Under New York law, the best evidence, and, if clear, the conclusive evidence, of the parties' intent, is

the plain meaning of the contract. Thus, in construing a contract under New York law, the Court should look to its language for a written agreement that is complete, clear, and unambiguous on its face; and, if that is the case, it must be enforced according to its plain terms. J. D'Addario & Company Inc. v. Embassy Industries, Inc., 20 N.Y.3d 113, 118 (2012); Greenfield v. Philles Records Inc., 98 N.Y.2d 562, 569 (2002).

A contract is ambiguous if its terms are "susceptible to more than one reasonable interpretation." Evans v. Famous Music Corp., 1 N.Y.3d 452, 458 (2004); see also British International Insurance Co. v. Seguros La Republica, S.A., 342 F.3d 78, 82 (2d Cir.2003), stating, "an ambiguity exists where the terms of the contract could suggest more than one meaning when viewed objectively by a reasonably intelligent person who has examined the context of the entire integrated agreement and who is cognizant of customs, practices, usages and terminology as generally understood in the particular trade or business."

Thus, while in instances of ambiguity the Court may look to parole evidence, if the agreement on its face is reasonably susceptible to only one meaning, that meaning governs; a court is not free to alter the contract to reflect its personal notions of fairness and equity. Greenfield v. Philles Records Inc., 98 N.Y.2d at 569; see also In re AMR Corp., 730 F.3d at 98.

Some additional points are worth emphasizing before proceeding to the language of the indenture itself. As noted in several of the foregoing authorities, the context of the entire agreement is important. The courts have cautioned (including when construing subordination language) that one should not take an isolated provision that might be susceptible to one or more readings out of context, but should apply it instead in the context of the entire agreement, or construe it in a way that is plausible in the context of the entire agreement. See, for example, Barclays Capital, Inc. v. Giddens, 2014 U.S.App. LEXIS 15009, at *21 (2d Cir. Aug. 5, 2014); In re Tribune Company, 472 B.R. 223, 255 (Bankr.D. Del. 2012), aff'd in part, vacated in part on other grounds, 2014 U.S. Dist. LEXIS 82782 (D. Del. June 18, 2014).

It is also fundamental that every word of the agreement should, to the extent possible, be given a meaning, or, in other words, one of the most basic interpretive canons is that a contract should be construed so that effect is given to all of its provisions and no part will be inoperative or superfluous or of no significance. See, for example, LaSalle Bank N.A. v. Nomura Asset Capital Corp. 424 F.3d 195, 206(2d Cir.2005); Lawyers' Fund for Client Protection v. Bank Leumi Trust Co. of New York, 94 N.Y.2d 398, 404 (2000).

It is also relevant, at least to confirm what appears to be an unambiguous provision or set of provisions in a contract, to consider the parties' interpretation of the contract in practice before litigation with respect to the underlying issue. See, for example, In re Actrade Financial Technologies, Ltd., 424 B.R. 59, 74 (Bankr.S.D.N.Y.2009), and In re Oneida, Ltd., 400 B.R. 384, 389 (Bankr.S.D.N.Y., 2009), aff'd 2010 U.S. Dist. LEXIS 6500 (S.D.N.Y. January 22, 2010).

Finally, the Court may be assisted in its understanding of the context of the contract by third party commentaries, particularly by seemingly nonpartisan industry groups like the ABA. See, for example, In re Metromedia Fiber Network, Inc., 416 F.3d 136, 139–40 (2d Cir.2005), as well as, at least when a contract's meaning is being clarified in context, Quadrant Structured Products Co., Ltd. v. Vertin, 2014 N.Y. LEXIS 1361, at *31–2 (N.Y. June 10, 2014).

***4** Having laid out these basic contract interpretation principles, let me turn to the language of the senior subordinated unsecured note indenture itself, noting first that both sides in this dispute have taken the position that these terms, although their import is disputed, are, in fact, unambiguous and susceptible to a plain meaning reading.

The operative paragraph providing for the subordination of the senior subordinated unsecured notes is Section 10.01 of the indenture, which provides in relevant part, "The Company [meaning the issuer/debtor] agrees, and each Holder, by accepting a Security agrees, that the Indebtedness evidenced by the Securities, is subordinated in right of payment, to the extent and in the manner provided in this Article 10, to the prior payment in full of all existing and future Senior Indebtedness of the Company and that the subordination is for the benefit of and enforceable by the holders of such Senior Indebtedness. The Securities shall in all respects rank pari passu in right of payment with all the existing and future Pari Passu Indebtedness of the Company and shall rank senior in right of payment to all existing and future Subordinated Indebtedness of the Company; and only Indebtedness of the Company that is Senior Indebtedness of the Company shall rank senior to the Securities in accordance with the provisions set forth herein."

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"Indebtedness" is defined in the indenture at page 19 as "(1) the principal and premium (if any) of any indebtedness"—lower case i—"of such Person whether or not contingent, (a) in respect of borrowed money, (b) evidenced by bonds, notes debentures or similar instruments or letters of credit or banker's acceptances (or, without duplication, reimbursement agreements in respect thereof), (c) representing the deferred or unpaid purchase price of any property," and other types of debt not relevant hereto;

and then, in paragraph (2), "to the extent not otherwise included, any obligation"—lower case o—"of such Person to be liable for, or to pay, as obligor, guarantor or otherwise, on the Indebtedness of another Person (other than by endorsement of negotiable instruments for collection in the ordinary course of business);

"(3) to the extent not otherwise included, Indebtedness of another Person secured by a Lien"—uppercase L—"on any asset owned by such Person (whether or not such Indebtedness is assumed by such person); provided, however, that the amount of such Indebtedness will be the lesser of: (a) the Fair Market Value of such asset at such date of determination, and (b) the amount of such Indebtedness of such other Person;"

and then (4), another type of indebtedness that is not relevant here; and there is a proviso that's also not relevant here, with respect to contingent obligations as deferred or prepaid revenues of purchase price holdbacks.

It is clear, therefore, from a plain reading of Section 10.01 of the indenture and the definition of "Indebtedness" that the indenture and, in particular, its subordination provision, provides for debt or claim subordination, not lien subordination.

There is a good example in the record of lien subordination, which I will get to, in the form of the Intercreditor Agreement among the second lien holders and the senior lien holders, as well as the debtors. However, it is clear from the subordination provision of Section 10.01 and the definition of "Indebtedness" that I previously quoted that the subordination of the senior subordinated unsecured notes is a subordination in respect of the payment of debt, and that the parties distinguished liens, which secure indebtedness, from indebtedness itself in several instances in the indenture, including in the definition of "Indebtedness" and "Lien," which is found on page 21 of the indenture: " 'Lien' means with respect to any asset, any mortgage, lien, pledge, charge, security interest or encumbrance of any kind in respect of such asset, whether or not filed, recorded or otherwise perfected under applicable law (including any conditional sale or other title retention agreement, any lease in the nature thereof, any option or other agreement to sell or give a security interest in and any filing of or agreement to give any financing statement under the Uniform Commercial Code (or equivalent statutes) of any jurisdiction)."

***5** Clearly, liens differ from indebtedness in common parlance and as defined in the indenture. Liens have a life of their own; they are not a characteristic of indebtedness but, rather, secure it.

Under Section 10.01 of the indenture, the senior subordinated noteholders have subordinated their right to payment of the debt owed to them to the extent provided for in the indenture to the prior payment in full of all existing and future "Senior Indebtedness." The issue comes down to, then, in large measure, the definition of "Senior Indebtedness" found at page 32 of the indenture, which provides, " 'Senior Indebtedness' means all Indebtedness and any Receivables Purchase Option of the Company or any Restricted Subsidiary, including interest thereon (including interest accruing on or after the filing of any petition in bankruptcy or for reorganization relating to the Company or any Restricted Subsidiary at the rate specified in the documentation with respect thereto, whether or not a claim for post-filing interest is allowed in such a proceeding) and other amounts (including fees, expenses, reimbursement obligations under letters of credit and indemnities) owing in respect thereof, whether outstanding on the Issue Date or thereafter incurred, unless the instrument creating or evidencing the same or pursuant to which the same is outstanding expressly provides that such obligations are subordinated in right of payment to any other Indebtedness of the Company or such Restricted Subsidiary, as applicable."

That last clause is the first proviso to "Senior Indebtedness." That is, Senior Indebtedness means all Indebtedness "unless the instrument creating or evidencing the same or pursuant to which the same is outstanding expressly provides that such obligations are subordinated in right of payment to any other Indebtedness of the Company." In other words, this first proviso states that indebtedness under the senior subordinated unsecured notes will not be subordinated to indebtedness under instruments that expressly provide that such indebtedness is itself subordinated debt.

Next, the indenture's definition of "Senior Indebtedness" sets forth a series of other exceptions or provisos, stating, "provided, however, that Senior Indebtedness shall not include, as applicable: (1) any obligation of the Company to any Subsidiary of the Company other than any Receivables Repurchase Obligation or any Subsidiary of the Company to the Company or any other Subsidiary of the Company [that is, intercompany debt is not Senior Indebtedness];

"(2) any liability for Federal, state, local, or other taxes owed or owing by the Company or such Restricted Subsidiary [that is, tax obligations are not Senior Indebtedness];

"(3) any accounts payable or other liability to trade creditors arising in the ordinary course of business (including guarantees thereof or instruments evidencing such liabilities)" [that is, trade debt is not Senior Indebtedness];

"(4) any Indebtedness or obligation of the Company or any Restricted Subsidiary that by its terms is subordinate or junior in any respect to any other Indebtedness or obligation of the Company or such Restricted Subsidiary, as applicable, including any Pari Passu Indebtedness;

***6** "(5) Any obligations with respect to any Capital Stock; or

"(6) any Indebtedness Incurred in violation of this Indenture, but as to any such Indebtedness Incurred under the Credit Agreement, no such violation shall be deemed to exist for purposeless of this clause (6) if the holders of such Indebtedness or their Representative shall have received an Officer's Certificate to the effect that the Incurrence of such Indebtedness does not (or, in the case of a Revolving Credit Facility thereunder, the Incurrence of the entire committed amount thereof at the date on which the initial borrowing thereunder is made, would not) violate this Indenture."

The subordinated noteholders contend that clause (4) of the definition of "Senior Indebtedness" which I have just quoted provides that (notwithstanding clause 4's failure to refer to liens) any indebtedness that would otherwise be Senior Indebtedness would not have the benefit of the indenture's subordination provision because of the fact that it is secured by a junior lien

Again, clause (4) to this series of additional provisos to the definition of "Senior Indebtedness" excludes any "Indebtedness or obligation of the Company or any Restricted Subsidiary that by its terms is subordinate or junior in any respect to any other Indebtedness or obligation of the Company or such Restricted Subsidiary, as applicable."

The subordinated noteholders contend (and it is basically their only argument) that the foregoing "junior in any respect" language would pick up, given the broad meaning of "in any respect," liens that are junior to other liens, and accordingly, indebtedness secured by such liens.

The debtors disagree, arguing that, when viewed pursuant to the contract interpretation principles that I have stated, clause (4) of this second group of provisos to the definition of "Senior Indebtedness" pertains only to debt subordination and not to lien subordination, consistent with the distinction throughout the indenture between liens and debt, on the one hand, and liens that secure such obligations, on the other, starting with Section 10.01.

After reviewing the indenture and the commentaries and other documents that were admitted into evidence in connection with this dispute, I agree with the debtors' interpretation of clause (4). I do so for a number of reasons, but primarily because of the wording of the clause itself and the fundamental contract interpretation principle that no material term of an agreement should be superfluous under one party's construction where it has a meaning under the other's, or, in other words, that the contract should be read to give effect to all of its provisions. See, again, LaSalle National Bank Association v. Nomura Asset Capital Corp., 424 F.3d at 206; Lawyers' Fund for Client Protection v. Bank Leumi Trust Co., 94 N.Y.3d at 404.

Under the definition of Senior Indebtedness that I've quoted, the parties first excluded Indebtedness where "the instrument creating or evidencing the same or pursuant to which the same is outstanding expressly provides that such obligations are subordinated in right of payment to any other Indebtedness of the Company." Then, in clause (4) of the definition, the parties further excluded "any Indebtedness or obligation of the Company or a Restricted Subsidiary that by its terms is subordinated or junior in any respect to any other Indebtedness or obligation of the Company." The subordinated noteholders' reading of clause (4) would swallow up the first exclusion that I have quoted. That is, under their interpretation, as long as any rights of a creditor are junior to any other creditor's rights, such as in respect of a junior-in-time or junior-by-agreement lien, the creditor's indebtedness is not Senior Indebtedness entitled to the benefit

of section 10.01. This broad reading of the exclusion in clause (4) would render the definition's first exclusion of expressly contractually subordinated debt superfluous.

***7** On the other hand, the debtors' interpretation of clause (4), which is that it applies to obligations that are by their terms subordinate even if not expressly so stated in the instrument creating the obligation, permits both exceptions to "Senior Indebtedness" to have a separate purpose. For example, obligations made subordinate to other obligations in a separate agreement, like an intercreditor agreement, or obligations that do not expressly state that they are subordinate to other obligations but are so by their terms, such as a "last out" facility in which one tranche of debt is to be paid after the rest of the debt under the same note, would fall within clause (4)'s exception but not into the first, introductory exception under the debtors' reading of the definition of Senior Indebtedness.

The debtors' interpretation also tracks the plain terms of clause (4), noting the difference between a debt and a lien that secures a debt. Thus clause (4) excepts from the definition of "Senior Indebtedness" "any Indebtedness or obligation of the Company or a Restricted Subsidiary that by *its* terms is subordinate or junior in any respect to any other Indebtedness or obligation." (Emphasis added.) The highlighted word "its" refers to the terms of the *Indebtedness* or the *obligation*—which are separate from the terms of a lien, mortgage, security interest, encumbrance, etc.—as being junior to any other Indebtedness or obligation, not to the terms of a *lien* being junior to any other lien.

The debtors also correctly point out that the commentary to the ABA model subordinated unsecured note indenture, appearing in Committee on Trust Indentures and Indenture Trustees ABA Section of Business Law, "Model Negotiated Covenants and Related Definitions," 61 Bus. Law. 1439 (Aug.2006), states that the form of clause (4) should be omitted if the obligor is "issuing junior subordinated securities." Id. at 62. Again, that is, the emphasis is on debt subordination, not lien subordination, junior subordinated securities being debt that is subordinated in any way by its terms to other debt. The commentary does not state that the clause should alternatively be omitted if the subordinated debt is intended to be pari passu with debt secured by a lien junior to another lien granted by the issuer.

The debtors' reading is also consistent with the rest of the indenture and the context of its subordination provision. The rationale, according to the subordinated noteholders, of an additional carve-out from Senior Indebtedness for indebtedness secured by a junior lien is the concern that junior lien financings could effectively overcome or get around or fit into a loophole in contracts pursuant to which one group of debt holders subordinate their debt to another. The second lien indebtedness would be senior debt, that is, layered ahead of the senior subordinated notes although secured by only a junior lien that, based on the value of the collateral, might be largely or entirely undersecured, something that senior subordinated unsecured noteholders would not necessarily want.

It does not appear, however, that there is any anti-layering provision in this indenture responsive to that underlying concern. To the contrary, there are covenants in the indenture that deal with the incurrence of additional debt, in section 4.03, the incurrence of additional liens, in section 4.12, and a limitation, in section 4.13, on senior or pari passu subordinated indebtedness that permit both the issuance of the second lien notes and, more importantly, permit them to be senior to the subordinated notes regardless of whether they were secured by a lien. Notwithstanding those specific provisions, however, the subordinated noteholders have proposed an interpretation of clause (4) in the definition of "Senior Indebtedness" that would essentially override those provisions and exclude the second lien notes from the benefit of Section 10.01 merely because they were secured.

***8** Moreover, the commentary upon which the senior subordinated noteholders base their argument that clause (4) was intended to close a loophole presented by junior lien financings points to the need, if one wants to exclude debt secured by a junior lien from the benefit of a subordination provision, to do so in an anti-layering covenant.

That is the case in the Fitch commentary, at page 275, which is attached as Exhibit L to Mr. Kirpilani's declaration, as well as the presentation to an American Bankruptcy Institute panel from 2006 attached as Exhibit J to his declaration, at pages 13–14. Indeed, the Thomson Reuters Legal Solutions Practical Law excerpt attached as Exhibit H to Mr. Kirpilani's declaration states at pages 4–5 that the better solution to deal with the concern about not being subordinated to second lien debt would be to place the exclusion in the anti-layering covenant itself or to add a new anti-layering provision.

The senior subordinated noteholders point to Section 1.04 of the indenture, which is entitled "Rules of Construction"

and includes as one of the parties' rules of construction, in clause (f), the following: "[U]nsecured Indebtedness shall not be deemed to be subordinate or junior to Secured Indebtedness [and thus excluded from the definition of Senior Indebtedness] merely by virtue of its nature as unsecured Indebtedness." They suggest that the absence of another, similar provision in the indenture, which *does* appear in the 2006 ABA's "Model Negotiated Covenants and Related Definitions" discussion, 61 Bus. Law. at 71, providing that "[S]ecured Indebtedness shall not be deemed to be subordinate or junior to any other secured Indebtedness merely because it has a junior priority with respect to the same collateral," establishes, under the principle of expressio unius est exlusio alterius, that the parties meant to exclude debt secured by a junior lien from the reach of the subordination provision.

However, I disagree with that interpretation. It seems to me that, instead, given the clear resolution of the parties' anti-layering rights, the plain meaning of the definition of "Senior Indebtedness" and the principle evident throughout the indenture that liens secure debt and are not themselves debt, there would be no need in the "Rules of Construction" section to have such a provision specifically *include* debt secured by a junior lien as Senior Indebtedness, in contrast to the need to add Section 1.04(f), which pertains to debt, not liens. In any event, it is clear from the ABA commentary, which dates from August 2006—just a few months before the issuance of the senior subordinated unsecured notes—and other presentations attached to Mr. Kirpilani's declaration that issues pertaining to the subordination of unsecured debt to debt secured by junior liens were still evolving when the senior subordinated unsecured notes were issued; there was no well established standard form that might add a meaningful context to the indenture's plain terms and internal consistency. Cf. Quadrant Structured Products Co., Ltd. V. Vertin, 2014 N.Y. LEXIS 1361, at *31–2 (relying, in addition to considerable precedent, on model no-action clause produced by the Ad Hoc Committee for Revisions of the 1983 Modified Simplified Indenture that predated the indenture at issue by 10 years).

***9** The subordinated noteholders' interpretation of "Senior Indebtedness" also would lead, to the anomalous result that their notes would be subordinated to senior unsecured debt (in this case, as suggested above, including the second lien debt, which, when issued, was unsecured because it had only a springing lien), but would cease to be subordinated when that lien sprung or when such debt was issued on a secured basis. There is no logical reason for such a distinction, notwithstanding the subordinated noteholders' attempt to find one.

The subordinated noteholders next contend that, even under the debtors' interpretation of "Senior Indebtedness," the Intercreditor Agreement entered into among the debtors, the second lien holders and the first lien and 1.5 lien holders, among others, and attached as Exhibit C to Mr. Kirpilani's declaration, goes *beyond* lien subordination (which I have found does not fit within the exception to "Senior Indebtedness"), providing, in essence, for the subordination of the second lien holders' *debt* to the debt secured by the liens of the first and 1.5 lien holders and any other debt that might be secured by senior liens.

The Intercreditor Agreement clearly does restrict the rights of the second lien holders, two of those restrictions having been highlighted by the subordinated noteholders. First, it provides that the second lien holders' right to the shared collateral is subordinate to the senior lien holders' right to such collateral, even if it turns out that the liens securing the senior lien debt are not perfected or enforceable. Second, it provides in paragraph 4.04 that the second lien holders shall turn over to the senior lien holders any recoveries that they obtain not only on account of their contractual liens on the shared collateral, but also on account of judicial liens that they may obtain.

However, contrary to the interpretation offered by the subordinated noteholders that these provisions of the Intercreditor Agreement are debt subordination provisions, they pertain to lien subordination, governing rights in respect of the shared collateral. Intercreditor agreements of this nature that pertain to secured creditors' lien rights are commonly geared to those rights whether or not the liens are perfected. The parties are certainly free to, and do, agree that their contractual liens, which they have mutually verified, are effective as among each other, even if such liens later prove to be generally ineffective because of a debtor's lien avoidance powers. The focus still is on the collateral that was agreed to be secured by the liens. See In re Ion Media Newworks, Inc., 419 B.R. 585, 594–95 (Bankr.S.D.N.Y.2009) ("By virtue of the Intercreditor Agreement, the parties have allocated among themselves the economic value of the FCC licenses as 'Collateral' (regardless of the actual validity of liens in these licenses.)").

Similarly, it is typical of intercreditor agreements among secured parties that rights to enforce interests in the collateral

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are, as they are here, thoroughly addressed. Accordingly, a provision stating that collections on a judicial lien (as well as from enforcement of the second lien holders' contractual lien) shall be turned over to the senior lien holders are common in shared collateral agreements, given that control over the collateral is a fundamental aspect of such agreements. See, for example the American Bankruptcy Institute presentation attached as Exhibit I to Mr. Kirpilani's declaration, at page 25, listing intercreditor agreement provisions that promote “first lienholders' desire to ‘drive the bus' in respect to remedies against the shared collateral.”

***10** In contrast, Section 5.04 of the Intercreditor Agreement provides that nothing in that agreement alters the second lien holders' rights in their capacity as *unsecured* creditors, again highlighting the distinction between lien subordination and debt subordination.

While there is no interpretive language contemporaneous with the parties' entry into the senior subordinated unsecured note indenture, the parties' subsequent actions further support the debtors' reading of the subordination provision's reach. For example, a substantial portion of the subordinated notes, roughly $118 million in face amount, was exchanged in 2009 at a discount of at least 60 percent for second lien notes, which is inconsistent with the subordinated noteholders' present argument that those notes are pari passu.

In addition, the trustees for the senior subordinated notes took no action with respect to the issuance of the second lien debt or the springing of the lien securing it, although arguably under the subordinated noteholders' current interpretation the debtors' disclosures with respect to the second lien notes—that they were senior in right of payment to the subordinated notes—was inaccurate. It is clear from the exhibits to the responses by the ad hoc committee of second lien holders and Apollo, as well as the debtors' submissions, that such disclosure was clear in the company's 8–K, 10–Ks, and prospectuses.

It is also the case that, under the subordinated noteholders' broad interpretation of clause 4's exception to “Senior Indebtedness,” the debt under the debtors' current first and 1.5 lien notes also would not benefit from Section 10.01's subordination provision, notwithstanding that the indenture's definition of “Designated Senior Indebtedness” would include the first and 1.5 lien notes. In other words, the definition of “Designated Senior Indebtedness” is not integrated into the definition of “Senior Indebtedness” as proposed by the subordinated noteholders, again rendering their broad interpretation of clause 4's exception to such definition highly unlikely in the context of the entire indenture.

The debtors, the ad hoc committee of second lien holders, and Apollo in its capacity as a second lien holder have also argued, in their briefs at least, that the subordinated noteholders are estopped by laches or other equitable principles from making the arguments that they are making now, given their silence in the face of the issuance of over a billion dollars of second lien debt that was widely disclosed to be senior in right of payment to the senior subordinated unsecured notes. At oral argument, the debtors and the second lien holders seem to have walked back on that argument, however, and I believe that it would not apply here under the case law, in any event, in light of the need to establish conduct upon which reliance is based and the absence of a factual record to show such reliance. See, for example, River Seafoods, Inc. v. J.P. Morgan Chase Bank, 796 N.Y.S.2d 71, 74 (1st Dept.2005) (stating elements of equitable estoppel under New York law), and Eppendorf–Netheler–Hinz GMBH v. National Scientific Supply Company Inc., 14 Fed. Appx. 102, 105 (2d Cir. July 13, 2001) (stating elements of laches under New York law).

***11** But, based on the plain meaning of Section 10.01 and the definition of “Senior Indebtedness,” and, secondarily, the distinction throughout the indenture, as well as when the relevant provisions are read context, between lien rights and the subordination of debt, I conclude that the second lien holders' notes are “Senior Indebtedness” and, therefore, entitled to the benefit of the subordination provision of Section 10.01 of the indenture.

The next two issues pertain to a different set of agreements that are subject to the same rules of contract interpretation that I've previously summarized and won't repeat, as both operative sets of agreements—indentures and notes—are governed by New York law. The two issues involve the rights of the indenture trustees, and therefore the holders, of the first and 1.5 lien holders to a so-called contractual “make-whole” claim, or, barring such a claim, a common law claim for damages, based on the debtors' payment of their notes before the original stated maturity of the notes. The first and 1.5 lien holders' rights to such a claim are in the first instance governed by the respective indentures and notes, which, as relevant, contain the same provisions.

If, in fact, the trustees are entitled to such a claim that is enforceable in bankruptcy, it will increase the amount of the replacement notes to be issued to the first and 1.5 lien holders as their distribution under the debtors' chapter 11 plan. That is, the plan leaves open, now that the classes of first and 1.5 lien holders have rejected the plan, for the Court to decide whether the first and 1.5 lien holders' allowed claim includes a make-whole amount, whereas, if those classes had accepted the plan they would have received a cash distribution in the amount of their allowed claims specifically without any make-whole amount.

The indentures for both sets of notes provide in Section 3.01, captioned "Redemption," that "the Notes may be redeemed, in whole, or from time to time in part, subject to the conditions and at the redemption prices set forth in paragraph 5 of the form of Notes set forth in Exhibit A and Exhibit B hereto, which are hereby incorporated by reference and made a part of this Indenture, together with accrued and unpaid interest to the redemption date."

Section 3.02 of each indenture states, "Applicability of Article. Redemption of Notes at the election of the Issuer or otherwise, as permitted or required by any provision of this Indenture, shall be made in accordance with such provision and this Article."

Section 3.03 sets forth the procedure pursuant to which the issuer, that is the debtors, "shall elect to redeem Notes pursuant to the optional redemption provisions of paragraph 5 of the applicable Note."

Section 3.06 of the indentures, entitled "Effect of Notice of Redemption," states, "Once notice of redemption is delivered in accordance with Section 3.05, Notes called for redemption become due and payable on the redemption date and at the redemption price stated in the notice, except as provided in the final sentence of paragraph 5 of the Notes."

Section 3.09 of each indenture, in contrast to the optional or elective redemption under sections 3.01 and 3.03 of the indentures and paragraph 5 of the notes, provides for a special mandatory redemption on the terms set forth in Section 3.09.

Paragraph 5 of the form of first and 1.5 lien notes states, "Optional Redemption. Except as set forth in the following two paragraphs, the Notes shall not be redeemable at the option of MPM prior to October 15, 2005. Thereafter, the Notes shall be redeemable at the option of MPM, in whole at any time or in part from time to time" as provided therein. And then it states, "In addition, prior to October 15, 2015, the Issuer may redeem the Notes at its option, in whole at any time or in part from time to time, upon not less than 30 nor more than 60 days' prior notice delivered electronically or mailed by first-class mail to each holder's registered address, at a redemption price equal to 100% of the principal amount of the Notes redeemed plus the Applicable Premium as of, and accrued and unpaid interest and Additional Interest, if any, to, the applicable redemption date (subject to the right of the Holders of record on the relevant record date to receive interest due on the relevant interest payment date)."

***12** "Applicable Premium" is separately defined in the indentures as follows: "With respect to any Note on any applicable redemption date, the greater of: (1) 1% of the then outstanding principal amount of such Note and (2) the excess of: (a) the present value at such redemption date of (i) the redemption price of such Note, at October 15, 2015 (such redemption price being set forth in paragraph 5 of the applicable Note) plus (ii) all required interest payments due on such Note through October 15, 2015 (excluding accrued but unpaid interest), computed using a discount rate equal to the Treasury Rate as of such redemption date plus 50 basis points; over (b) the then outstanding principal amount of such Note."

The indenture trustees for the first and 1.5 lien notes argue that the chapter 11 plan's payment of the holders with replacement notes entitles them to the Applicable Premium, as they will receive such notes before October 15, 2015. They contend that such payment would be an optional or elective redemption under the provisions of the indentures and notes that I have just read.

As I've noted and will discuss later, the trustees for the first and 1.5 lien notes also argue that, even if they are not entitled by contract to an Applicable Premium constituting a make-whole under these circumstances, they nevertheless have a claim under otherwise applicable law or the first sentence of paragraph 5 of the notes, which they contend is a "non-call" covenant, that is triggered by the debtors' early payment of their notes in the form of replacement notes under the plan, although the amount of such claim, or formula therefor, is not set forth in the indentures or the notes.

Let me address the Applicable Premium argument first. It is well established that when considering the allowance of a claim in a bankruptcy case the court first considers whether

the claim would be valid under applicable nonbankruptcy law, and then, second, if the claim is valid under applicable nonbankruptcy law, whether there is any limitation on or provision for disallowance of the claim under the Bankruptcy Code. See Ogle v. Fidelity & Deposit Company of Maryland, 586 F.3d 143, 147–48 (2d Cir.2009); HSBC Bank U.S.A. v. Calpine Corp., 2010 U.S. Dist. LEXIS 96792, at *18 (S.D.N.Y. Sept. 15, 2010).

It is well settled under New York law, which is, again, the law governing these agreements, that the parties to a loan agreement, indenture or note can amend the general rule under New York law of "perfect tender" to provide for a specific right on behalf of the borrower or issuer to prepay the debt in return for agreed consideration that compensates the lender for the cessation of the stream of interest payments running to the original maturity date of the loan. Without that contractual option, under the New York rule of perfect tender the borrower/issuer would be precluded from paying the debt early. See U.S. Bank National Association v. South Side House LLC, 2012 Dist. LEXIS 10824, at *12–13 (E.D.N.Y. January 30, 2012), as well as Northwestern Mutual Life Insurance Company v. Uniondale Realty Associates, 816 N.Y.S.2d 831, 835, 11 Misc.3d 988, 984 (N.Y.Sup.Ct.2006). See generally Charles & Kleinhaus, "Prepayment Clauses in Bankruptcy," 15 Am. Bankr.Inst. L.Rev. 537, 541 (Winter 2007) ("Charles & Kleinhaus"), and the cases cited therein at 541 n.13, applying New York's perfect tender rule.

It is also well-settled law in New York that a lender forfeits the right to such consideration for early payment if the lender accelerates the balance of the loan. The rationale for this rule is logical and clear: by accelerating the debt, the lender advances the maturity of the loan and any subsequent payment by definition cannot be a prepayment. In other words, rather than being compensated under the contract for the frustration of its desire to be paid interest over the life of the loan, the lender has, by accelerating, instead chosen to be paid early. See U.S. Bank National Association v. South Side House, 2012 U.S. Dist. LEXIS 10824, at *13–14, and the cases cited therein, including In re LHD Realty Corp., 726 F.2d 327, 331 (7th Cir.1984); In re Solutia, Inc., 379 B.R. 473, 487–88 (Bankr.S.D.N.Y.2007); In re Granite Broadcasting Corp., 369 B.R. 120, 144 (Bankr.S.D.N.Y.2007); and Northwestern Mutual Life Insurance Company v. Uniondale Realty Associates, 816 N.Y.S.2d at 836.

***13** There are two well-recognized exceptions to that proposition. The first is agreed not to apply here, namely when the debtor intentionally defaults in order to trigger acceleration and evade the prepayment premium or make-whole, the debtor will remain liable for the make-whole notwithstanding acceleration of the debt. See Sharon Steel Corp. v. The Chase Manhattan Bank. N.A., 691 F.2d 1039, 1053 (2d Cir.1982). Here, even if the trustees had not conceded this point, it is clear that the debtors' bankruptcy is not simply a tactical device to deprive the first and 1.5 lien holders of a make-whole claim.

The second exception, which is at issue here, is when a clear and unambiguous clause calls for the payment of a prepayment premium or make-whole even in the event of acceleration of, or the establishment of a new maturity date for, the debt. See, again, U.S. Bank National Association v. South Side House, 2012 U.S. Dist. LEXIS 10824, at *14–16 and *23; Northwestern Mutual Life Insurance Company v. Uniondale Realty Associates, 816 N.Y.S.2d at 836, and the cases cited therein. Thus, the first and 1.5 lien holders' right to an Applicable Premium, or make-whole, hinges on whether the relevant sections of their indentures and notes provide with sufficient clarity for the payment of such premium after the maturity of the notes has been accelerated.

Critically important, therefore, is another provision of the indentures, Section 6.02, which provides generally that the trustee or the holders of at least 25 percent of principal amount of the outstanding notes, upon an event of default, can elect to accelerate the notes, but also states, "If an Event of Default specified in Section 6.01(f) or (g) with respect to MPM [which includes the debtors' bankruptcy] occurs, the principal of, premium, if any, and interest on all the Notes shall ipso facto become and be immediately due and payable without any declaration or other act on the part of the Trustee or any Holders."

The form of note attached to the indentures also provides, in paragraph 15, "If an Event of Default relating to certain events of bankruptcy, insolvency or reorganization of the Issuer occurs, the principal of, premium, if any, and interest on all the Notes shall become immediately due and payable without any declaration or other act on the part of the Trustee or any Holders."

(Section 6.02 in the indentures also provides, in its final sentence, "The Holders of a majority in principal amount of outstanding Notes by notice to the Trustee may rescind any such acceleration with respect to the Notes and its consequences," and the last sentence of paragraph 15 of the

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notes states, "Under certain circumstances, the Holders of a majority in principal amount of the outstanding Notes may rescind any such acceleration with respect to the Notes and its consequences." The first and 1.5 lien trustees' arguments to rescind acceleration of the notes are discussed in the third section of this ruling)

In light of the automatic acceleration of the notes under Section 6.02 of the Indentures, as also obliquely referenced in paragraph 15 of the notes, upon the debtors' bankruptcy filing, the debtors and the second lien holders contend that the maturity date of the notes has been contractually advanced and, thus, under New York law the first and 1.5 lien holders, having provided for acceleration in the applicable agreements, bargained for prepayment of the notes upon the event of the debtors' bankruptcy and therefore forfeited their right to the Applicable Premium.

***14** (In addition, the debtors and the second lien holders contend that the debtors' payment of the first and 1.5 lien holders as required by the Bankruptcy Code before the original maturity of the notes (or at least before October 15, 2015) is not elective or voluntary, and, therefore, again, does not subject the debtors to the Applicable Premium owed upon an elective redemption under the express terms of Sections 3.02–3.03 of the indentures and paragraph 5 of the notes. The debtors have the option under section 1124 of the Bankruptcy Code, however, to reinstate the first and 1.5 lien notes rather than pay them with substitute consideration, under a chapter 11 plan. In addition, the notice requirements of Bankruptcy Rule 2002 arguably functionally track the election/notice process provided in sections 3.03 and 3.05 of the indentures. Thus, I have not further considered this argument of the debtors and second lien holders in light of the efficacy of their first argument.)

As noted previously, it is "well-settled law," South Side House, 2012 U.S. Dist. LEXIS 10824, at *12, that, unless the parties have clearly and specifically provided for payment of a make-whole (in this case the Applicable Premium), notwithstanding the acceleration or advancement of the original maturity date of the notes, a make-whole will not be owed. Such language is lacking in the relevant sections of the first and 1.5 lien indentures and notes; therefore, they do not create a claim for Applicable Premium following the automatic acceleration of the debt pursuant to Section 6.02 of the indentures. In addition to the cases that I have already cited for this proposition, see In re Madison 92nd Street Associates, LLC, 472 B.R. 189, 195–96 (Bankr.S.D.N.Y.2012); In re LaGuardia Associates LLP, 2012 Bankr.LEXIS 5612, at *11–13 (Bankr.E.D.Pa. Dec. 5, 2012); In re Premiere Entertainment Biloxi, LLC, 445 B.R. 582, 627–28 (Bankr.S.D.Miss.2010), and the cases cited therein, all of which interpret New York law, and some of which involve automatic acceleration clauses, which, as noted by the district court in South Side House, have the same negating effect as the voluntary exercise of an acceleration right, given that such clauses were negotiated by the parties. 2012 U.S. Dist. LEXIS 10824, at *20–23. See also In re AMR Corporation, 730 F.3d at 101, in which the Second Circuit made clear that such an automatic acceleration provision operates by the choice of the indenture trustee as much as the issuer/debtor; that is, such contractual automatic acceleration is not voluntary on the issuer's part because it is an enforceable covenant, including not being subject to invalidation under any section of the Bankruptcy Code, such as section 365(e), which would negate so-called ipso facto provisions triggered by a debtor's bankruptcy filing.

The trustees for the first and 1.5 lien holders try to get around the problem that their documents do not contain sufficient language triggering an Applicable Premium after acceleration in a couple of ways, one of which is to refer to a discussion in In re Chemtura Corporation, 439 B.R. 561, 596–02 (Bankr.S.D.N.Y.2010), in which Judge Gerber evaluated the settlement of a make-whole dispute that was opposed by those who contended that the beneficiaries of the settlement, who were receiving a range of 39 and 43 percent of their make-whole claim under it, should really recover nothing or at least far less than that amount on account of such claims.

The trustees contend that Judge Gerber concluded that a covenant triggering a make-whole amount upon a prepayment by a date certain would be a specific enough of a reference to the make-whole's being owed, notwithstanding the acceleration of the debt, to satisfy the explicitness requirement in the cases that I have previously cited.

I should note, however, that, in addition to the settlement context in which Judge Gerber gave his analysis, where he considered only whether the settlement lay within the lowest bounds of reasonableness, he was focusing in Chemtura not on a specific date like the pre-October 15, 2015 date set forth in paragraph 5 of the notes here, but, rather, on a provision that was triggered off a *differently defined maturity date* than the original maturity date, thus keying liability for the make-whole back to the need, as stated in the cases that I have cited, to state clearly that the premium would be owed

notwithstanding the acceleration of the original maturity date. Id. at 601

***15** That is not the case under the notes and the indentures here. Indeed, in each of the reported cases that quote language that would be explicit enough to overcome the waiver of the make-whole upon acceleration under New York law, more was required than is contained in the relevant sections of the indentures and notes that I have quoted—either an explicit recognition that the make-whole would be payable notwithstanding the acceleration of the loan or, as stated by Charles & Kleinhaus, a provision that requires the borrower to pay a make-whole whenever debt is repaid prior to its *original* maturity, which is in essence what Judge Gerber was referring to in the Chemtura case. See Charles & Kleinhaus, 15 Am. Bankr.Inst. L.Rev. at 556. See also, for examples of the type of specificity required to satisfy applicable New York law, the discussion in U.S. Bank National Association v. South Side House, LLC, 2012 U.S. Dist. LEXIS, 10824, at *21–24, and In re LaGuardia Associates, L.P., 2012 Bankr.LEXIS 5612, at *14–16.

That type of specificity works notwithstanding the purpose of a make-whole, which is to ensure that the lender is compensated for being paid earlier than the original maturity of the loan for the interest it will not receive, because make-wholes are properly viewed as an option pursuant to which the parties have allocated the cost of prepayment between themselves. South Side House, 2012 U.S. Dist. LEXIS 10824, at *22–23; Northwestern Mutual Life Insurance Company v. Uniondale Realty Associates, 816 N.Y.S.2d at 984; Charles & Kleinhaus, 15 Am. Bankr.Inst. L.Rev. at 566–67. However, the option, as noted, must be specific if the parties want it to apply even after acceleration of the debt.

The trustees for the first and 1.5 lien notes also contend that, even if they are not entitled to an Applicable Premium, other provisions of the indentures refer to a lower case "prepayment premium." For example, as I noted, Section 3.02 of the indentures refers to the "Redemption of Notes at the election of the Issuer *or otherwise* as permitted or required by any provision of this Indenture shall be made in accordance with such provision in this Article." (Emphasis added.) (Although it should be noted that Section 3.09 of the indentures provides for a mandatory redemption, which is what the "or otherwise" reference in Section 3.02 apparently addresses.) In addition, they point out that Section 6.02 of the indentures provides for the automatic acceleration upon the debtors' bankruptcy of "the principal of, *premium, if any,* and interest on all the Notes" (emphasis added), and Section 6.03 states that "If an Event of Default occurs and is continuing, subject to the terms of the New Intercreditor Agreement or the Junior Priority Intercreditor Agreements, the Trustee may pursue any available remedy at law or equity to collect the payment of principal of or interest on the Notes or to enforce the performance of any provision of the Notes, this Indenture or the Security Documents" (that is, acknowledging the trustees' common law enforcement rights, which, the trustees, contend, would include the payment of a prepayment premium).

Each of these references to other rights or "premiums, if any," to be paid upon prepayment are not specific enough, however, to overcome the requirement of New York law that I have previously outlined in order for a make-whole or prepayment claim to be payable post-acceleration.

Moreover, the "if any" language that I've quoted refers back to the actual provisions of the indentures and notes, the only one of which that specifically provides for an optional redemption and payment of a specific premium (the Applicable Premium) does not sufficiently provide for payment after acceleration under New York law, as previously discussed. A similar provision appeared in the instrument at issue in In re LaGuardia Associates, L.P., 2012 Bankr.LEXIS 5612, and Judge Raslavich construed it much as I have here, stating, "On the contrary, [such provision] references 'any payment required to be paid under the note.' That returns the inquiry back to Section 1.02(b) of the note and its description of the specific two events which have not occurred." Id. at *19–20. Similarly, Section 3.02 of the indentures, which states, "Redemption of Notes at the election of the Issuer or otherwise, as permitted or required by any provision of this Indenture, shall be made in accordance with such provision and this Article," does not create a separate make-whole right enforceable upon acceleration of the debt but only refers to rights that may be triggered in accordance with the specific provisions of Article 3.

***16** It is also the case that Section 3.06 of the indentures, which states that "Once notice of redemption is delivered in accordance with Section 3.05, Notes called for redemption become due and payable on the redemption date and at the redemption price stated in the notice, except as provided in the final sentence of paragraph 5 of the Notes," is superseded by the automatic acceleration upon the issuer's bankruptcy, provided for in Section 6.02. That is, the foregoing language from the Section 3.06 is not a substitute for acceleration, which made the notes due and payable on

the bankruptcy petition date, or a clear enough statement that, notwithstanding acceleration, the redemption date, that is, the date upon which the issuer would call the notes for redemption, would artificially jump ahead of the prior acceleration or ignore the acceleration and entitle the holders to a make-whole under New York law.

Therefore, the indentures and notes do not overcome or satisfy the requirement under New York law that a make-whole be payable specifically notwithstanding acceleration or payment prior to the original maturity date under the terms of the parties' agreements. There is, therefore, no claim for Applicable Premium or any other amount under the indentures and notes for the first and 1.5 lien holders that would be triggered by the lien holders' treatment under the debtors' chapter 11 plan, or any other payment of their notes following their automatic acceleration under Section 6.02 of the indenture.

This leaves to be decided the first and 1.5 lien holders' remaining claim based on payment, under the chapter 11 plan by new replacement notes, of the first and 1.5 notes prior to their maturity that would arise, they contend, under New York's common law rule of perfect tender or, as argued by the trustees, under the first sentence of paragraph 5 of the notes. That sentence, they contend, sets forth a "non-call" covenant when it states, "Except as set forth in the following two paragraphs [which reference payments of contractual make-whole that I have just ruled are not here owing], the Note shall not be redeemable at the option of MPM prior to October 15, 2015."

The debtors and the second lien holders argue that this sentence is no more than an introduction or framing device for the notes' elective redemption provisions in return for payment of the Applicable Premium, which immediately follow the "non-call" sentence, and is not a specific contractual non-call provision. In support of this contention, they point out that the make-whole right actually arises under Sections 3.01–3.03 of the indentures, which then reference paragraph 5 of the notes, which states the right to a make-whole amount under certain circumstances. They are right: the indentures and notes do not contain a covenant stating the amount owing upon the voluntary call of the notes with the exception of sections 3.01–3.03 and the definition of Applicable Premium.

This leaves the trustees with the argument that New York's common law of perfect tender would apply even if their agreements were silent regarding the consequences of such prepayment. That is, the trustees for the first and 1.5 lien notes contend that the holders are entitled to a claim under New York law for a prepayment premium based merely on the fact of prepayment, which, they point out, would be preserved under the general reservation of common law rights and remedies set forth in Section 6.03 of the indentures.

As noted previously, New York law would, in fact, provide for such a claim for breach of the rule of perfect tender, at least one for specific performance. However, applying the two-step claim analysis required by Ogle v. Fidelity & Deposit Company of Maryland, 586 F.3d at 147–48, the trustees would not have an allowable claim for such damages under the Bankruptcy Code, because this is one of the few instances when specific provisions of the Bankruptcy Code disallow such a claim—section 506(b), as well as section 502(b)(2), which disallows claims for unmatured interest.

***17** First, it is well recognized that, notwithstanding New York's perfect tender rule, such right is not enforceable by specific performance in a bankruptcy case, given the Bankruptcy Code's non-contractual acceleration of debt for claim determination purposes. See, for example, HSBC Bank USA v. Calpine Corp., 2010 U.S. Dist. LEXIS 96792, at *11–14, and Charles & Kleinhaus, 15 Am. Bankr.Inst. L.Rev. at 563–64.

In addition, as noted, no provision of the indentures and notes (except as already found to be inapplicable in light of the acceleration of the debt) provides for an additional premium to be paid upon the prepayment of the notes. Thus, the claim would not fall under the allowed claim provided to oversecured creditors for fees and charges under the parties' agreement under section 506(b) of the Bankruptcy Code up to the value of their collateral. See HSBC Bank USA v. Calpine Corp., 2010 U.S. Dist. LEXIS 96792, at *14–21; In re Solutia Inc., 379 B.R. at 485; In re Calpine Corp., 365 B.R. 392(Bankr. S.D.N.Y. 2007), rev'd on other grounds, 2011 U.S. Dist. LEXIS 62100 (S.D.N.Y. June 7, 2011); and In re Vest Assocs., 217 B.R. 696, 699 (Bankr.S.D.N.Y.1998).

It is not clear whether a claim for breach of a contractual make-whole provision should be viewed as a claim for unmatured interest (compare In re Trico Marine Services, Inc., 450 B.R. 474, 480–81 (Bankr.D.Del.2013) (recognizing split of authority but holding that claim for breach of contractual make-whole is liquidated damages for breach of an option to prepay, not for unmatured interest), and In re

Doctors Hospital of Hyde Park, Inc., 508 B.R. 596, 605–06 (Bankr.N.D.Ill.2014) (claim for breach of contractual yield maintenance premium is for unmatured interest not paid as a result of prepayment)). However, the measure of a claim based on New York's rule of perfect tender or a non-call right that does not provide for liquidated damages would be the difference between the present value of the interest to be paid under the first and 1.5 lien notes through their stated maturity and the present value of such interest under the replacement notes to be provided to the fist and 1.5 lien holders under the chapter 11 plan, which should equate to unmatured interest. See Charles & Kleinhaus, 15 Am. Bankr.Inst. L.Rev. at 541–42, 580–81. Accordingly such a claim also would be disallowed as unmatured interest under section 502(b)(2) of the Bankruptcy Code. It is not interest that has accrued during the bankruptcy case, but would, rather, accrue in the future, at least to 2015 if not to 2020, the original maturity date of the notes, and, therefore, would not be an allowed claim under section 502(b)(2). HSBC Bank USA v. Calpine Corp., 2010 U.S. Dist. LEXIS, at *14–21.

The two cases relied upon by the first and the 1.5 lien trustees for the contrary proposition actually are consistent with the foregoing analysis. The debtors in both cases (unlike here) were solvent and, therefore, the courts found them to be subject to an exception to section 502(b)(2) of the Code's disallowance of claims for unmatured interest under either equitable principles, as set forth in the legislative history to section 1124 of the Bankruptcy Code (see 140 Cong. Rec. H 10,768 (October 4, 1994)), or because of the application of the best interests test in section 1129(a)(7) of the Code when the debtor is solvent. See In re Premier Entertainment Biloxi, LLC, 445 B.R. at 636–37; In re Chemtura Corp., 439 B.R. at 636–37.

***18** This analysis applies also to any claim premised on the debtors' breach of the provision in the last sentence Section 6.02 of the indentures, obliquely referenced in paragraph 15 of the notes, that the issuer would under certain circumstances permit the rescission of automatic acceleration under Section 6.02 upon the issuer's bankruptcy. The damages for breach of such a rescission right, which are unspecified in both the indentures and the notes, would equate to the same lost unmatured interest that would apply to a breach of the right of perfect tender or non-liquidated damages non-call right.

Accordingly, I conclude both for purposes of confirmation of the debtors' chapter 11 plan, as well as for Adversary Proceeding Nos. 14–08227 and 14–08228, that the plain language of the first and 1.5 lien indentures and notes as applied to the present facts requires the allowed claim of the indenture trustees for the first and 1.5 lien holders to exclude any amount for Applicable Premium or any other damages based on the early payment of the notes.

There is no relevant commentary or conduct by the parties that would or should change that view, given that there is no ability to consider parol evidence in light of the plain meaning of the agreements under the contract interpretation cases that I have already cited. I will note, however, that the trustees for the first and 1.5 lien holders have contended that the disclosure in the prospectuses for their notes, while lengthy, fails to highlight the risk that, upon bankruptcy and the automatic acceleration of the notes, no make-whole claim or other damages would be owed upon the early payment of the notes.

It is true that there is no such disclosure. I note, however, that the vast majority of risk disclosures in the prospectuses, 54 risk factors, pertains to fact-based risks—either market or business or product risks. Of the risk factors disclosed, only six are bankruptcy-related, and they do not specifically disclose material risks affecting the notes in the issuer's bankruptcy in addition to the risk to the make-whole claim. Two disclosed bankruptcy-related risks pertain to the potential avoidance of the notes or the liens under chapter 5 of the Bankruptcy Code. Others state that the ability of holders to realize upon their collateral and claims is subject to certain bankruptcy law limitations (which may, in fact, include, in broad scope, the risk that the first and 1.5 lien holders may not have an allowed claim based on prepayment of the notes in a bankruptcy case, although perhaps such disclosure could simply be taken as a reference to the imposition of the automatic stay under section 362(a) of the Bankruptcy Code). But, as noted, there are other specific bankruptcy risks in addition to risks to the allowance of a make-whole claim that are not disclosed, including the risk of being crammed down with notes payable over time, as opposed to being paid in cash or reinstated, under section 1129(b)(2) of the Bankruptcy Code.

Moreover, as observed by the Court in South Side House, 2012 U.S. Dist. LEXIS 10824, at *12, the law that I have applied to the first and 1.5 lien holders' make-whole claim is "well-settled" and long established. It has been stated readily and cogently by courts that do not specialize in New York law; i.e., courts from the Seventh, Third, and Fifth Circuits, the latter two from Pennsylvania and Mississippi, as well

as Delaware. Thus it does not appear, to the extent that one would even give any weight to the disclosure, or lack thereof, in the prospectuses, that the noteholders needed to be specially alerted to the risk that their make-whole claims might be disallowed in bankruptcy based on the automatic contractual acceleration of their notes, beyond the disclosure that the issuer's bankruptcy might alter the noteholders' rights.

***19** Relatedly, as I've noted, the first and 1.5 lien trustees have sought freedom from the automatic stay under section 362(a) of the Bankruptcy Code to implement the rescission of the automatic acceleration of the notes that occurred under Section 6.02 of the indentures upon the debtors' bankruptcy filing. The mechanism for such rescission is also set forth in Section 6.02 of the indentures and is loosely referenced in paragraph 15 of the notes, which states, "Under certain circumstances, the Holders of a majority in principal amount of the outstanding Notes may rescind any such acceleration with respect to the Notes and its consequences."

The first and 1.5 lien holders want to rescind the contractual acceleration under Section 6.02 to avoid the fatal effect of such acceleration upon their make-while rights in light of their agreements' lack of the specificity required to trigger the Applicable Premium upon acceleration under New York law.

The trustees make three arguments to support their request. First, they state that the automatic stay does not actually apply to sending a rescission notice. Second, they contend that, even if the automatic stay under section 362(a) of the Code applies to such a notice, rescission is excepted from the stay by section 555 of the Bankruptcy Code. Finally, they contend that, even if the automatic stay applies, they should be granted relief from the stay pursuant to section 362(d) of the Code.

I conclude that the automatic stay does, in fact, apply to the sending of a rescission notice and contractual deceleration of the debt. Two provisions of the Bankruptcy Code's automatic stay apply here. First, section 362(a)(3) of the Code states that the automatic stay upon the filing of the case includes a stay of "any act to obtain possession of property of the estate or property from the estate or to exercise control over property of the estate." Section 362(a)(6) then states that the following also are stayed: "any act to collect, assess or recover a claim against the debtor that arose before the commencement of the case under this title."

In essence, as I've said, the first and 1.5 lien trustees seek through a rescission notice to exercise a right under the indentures, which, as contracts to which the debtors are a party, are property of the debtors' estates. The purpose of sending a rescission notice would be to enable the holders to recover a sizeable claim against the debtors—that is, to resurrect their make-whole claim, which has been loosely quantified as approximating $200 million—through deceleration of the debt. They thus seek to control property of the estate by exercising a contract right to the estate's detriment and recover, by decelerating, a claim against the debtors.

The Second Circuit has recently held in a very similar context that sending such a notice would, in fact, be subject to the automatic stay of section 362(a). In re AMR Corp., 730 F.3d at 102–03 and 111–12, citing In re 48th Street Steakhouse, Inc., 835 F.3d, 427 (2d Cir.1987), and In re Enron Corp., 300 B.R. 201 (Bankr.S.D.N.Y.2013), in which contract rights were found to be property of the debtor and actions that had the effect of terminating, or would, in fact, terminate or alter, those rights, even if taken against a third party, as in 48th Street Steakhouse, would therefore constitute the exercise of control over property of the estate stayed by section 362(a)(3). See also In re Solutia Inc., 379 B.R. at 484–85.

Additionally, here, as in AMR and Solutia, the purpose of sending such a notice would be to recover a claim against the debtors, because the first and most important step in recovering a make-whole claim would be to resurrect the right to the Applicable Premium by decelerating the debt. Therefore, it is clear that the automatic stay under section 362(a)(6) of the Code also applies.

***20** The trustees have argued that a rescission notice would not alter what the *debtors* would retain under the plan, and, therefore, that section 362(a)(3) should not apply, because this is fundamentally, or economically, an intercreditor dispute; i.e., the value—the $200 million— that the first and 1.5 lien holders seek to include as part of their claim if rescission and deceleration is permitted, would otherwise effectively be distributed to the second lien holders and the trade creditors under the plan.

However, that is not a proper reading of section 362(a) of the Bankruptcy Code. As noted by the court in In re Strata Title, LLC, 2013 Bankr.LEXIS 1704 at *17–18 (Bankr.D Az. Apr. 25, 2013), such a reading of section 362(a)(3) would add a phrase to the statute that is not present, namely "unless such act would provide economic value to the estate." Moreover, it ignores the applicability of section 362(a)(6).

This is also clearly not a case, as the trustees contended at oral argument, where the automatic stay wouldn't apply because the transaction is only between third parties, in the nature of a letter of credit draw which is not subject to the automatic stay because the issuer has a separate and independent obligation to the beneficiary the payment of which does not control the debtor's property; rather, the effect on the debtors' estates of the requested rescission and deceleration would be direct —controlling and increasing the first and 1.5 lien holders' recovery of property of the estate.

Similarly, Second Circuit cases cited by the trustees for the proposition that, "[t]he general policy behind section 362(a) is to grant complete immediate, albeit temporary, relief to the debtor from creditors and also to prevent dissipation of the debtor's assets before any distribution to creditors can be effective," SEC v. Brennan, 230 F.3d 65, 70 (2d Cir.2000), are taken entirely out of context, whereas the trustees ignore numerous cases, discussed below, in which the courts have prohibited, as did the Second Circuit in AMR, actions that would permanently alter, postpetition, the rights of creditors that existed on the petition date, such as by sending notices like the rescission notice at issue here.

It is clear that there is a difference between automatic acceleration pursuant to a contract, as is the case here, and acceleration generally as a matter of bankruptcy law upon the commencement of a bankruptcy case for the purpose of determining claims against the estate, as I'll discuss in more detail when I consider whether relief should be granted from the stay pursuant to section 362(d) of the Code. For present purposes, however, it is sufficient to note that here a contract to which the debtors are a party would specifically be affected for the purpose of recovering on a claim against the debtors, and, therefore, the automatic stay under section 362(a) of the Bankruptcy Code applies.

In addition, the indenture trustees make an argument that was not raised in AMR or Solutia: that the sending of a rescission notice to decelerate the first and 1.5 lien notes would merely be liquidating a securities contract, which is permissible under section 555 of the Bankruptcy Code notwithstanding the automatic stay under section 362(a).

Section 555 of the Bankruptcy Code provides, "The exercise of a contractual right of a stockbroker, financial institution, financial participant or securities clearing agency to cause the liquidation, termination or acceleration of a securities contract as defined in section 741 of this title, because of a condition of the kind specified in section 365(e) of this title [i.e., so called "ipso facto" conditions such as the commencement of the bankruptcy case], shall not be stayed, avoided or otherwise limited by operation of any provision of this title."

***21** The first and 1.5 lien trustees contend that the effect of the rescission notice would be to fix and, therefore, liquidate, the amount of their claims in the bankruptcy case and, therefore, that it would, pursuant to section 555 of the Code, not be subject to the automatic stay. There are several problems with this argument, however.

First, I have serious doubts that the indenture itself is a securities contract as defined in section 741(7)(A) of the Bankruptcy Code, at least with respect to this issue. Generally speaking, section 741(7) of the Code's definition of "securities contract," which is lengthy, states that it is a contract for the purchase, sale or loan of a security. Clearly, the indentures themselves are not contracts for the purchase, sale or loan of a security; they instead set forth the terms under which the underlying notes will be governed and the role of the trustees in connection therewith. See In re Qimonda Richmond, LLC, 467 B.R. 318, 323 (Bankr.D.Del.2012), holding, albeit without much discussion, that an indenture does not fall within the definition of section 741(7)(A).

The trustees rely on subsection (A)(x) of section 741(7) of the Code to fit the indentures within the "securities contract" definition notwithstanding that the indentures themselves are not contracts for the purchase, sale or loan of a security. Section 741(7)(A)(x) states, in relevant part, "A 'securities contract' means ... (x) a master agreement that provides for an agreement or transaction referred to in [among other sub-clauses] clause (i)[that is, a contract for the purchase, sale, or loan of a security, among other transactions], without regard to whether the master agreement provides for an agreement or transaction that is not a securities contract under this subparagraph, except that such master agreement shall be considered to be a securities contract under this subparagraph only with respect to each agreement or transaction under such master agreement that is referred to in clause (i) [i.e., a contract for the purchase, sale or loan of a security]."

It is far from clear that the indentures would be viewed as such a master agreement, however, given the proviso in the last clause of subsection 741(A)(x), with respect to the indentures' rescission section, which does not itself

pertain to the purchase, sale or loan of the notes and, further, because paragraph 15 of the notes does not specify any rescission right but instead refers to a right that is exercisable under unidentified provisions upon certain unspecified circumstances.

Relatedly, and even more significantly, I do not believe that sending the rescission notice, the consequences of which, as I have stated, would enable the deceleration of the notes to permit the increase of a claim against the debtors in the amount of the make-wholes, is in fact covered by section 555 of the Bankruptcy Code, because it is not a “liquidation” as contemplated by that section.

The customary interpretation of section 555 is that it “provides a tool for the non-defaulting ... participant to exercise its contractual right to close-out, terminate or accelerate a ‘securities contract.’ Such a close-out or liquidation typically entails termination or cancellation of the contract, fixing of the damages suffered by the nondefaulting party based on market conditions at the time of liquidation, and accelerating the required payment date of the net amount of the remaining obligations and damages.” In re American Home Mortgage, Inc., 379 B.R. 503, 513(Bankr.D. Del 2008), quoting 5 Collier on Bankruptcy, paragraph 555.04 (16th ed.2014).

***22** Here, to the contrary, the first and 1.5 lien trustees look to *de* celerate and create a *different* claim than existed on the bankruptcy petition date. As discussed by Judge Peck in decisions in the Lehman Brothers case pertaining to a closely analogues provision of the Bankruptcy Code, section 560, that type of action does not fall within section 555 of the Bankruptcy Code, which, with its companion sections, is a narrow provision that should not be used to improve a contract party's standing or claim in the bankruptcy case. See Lehman Brothers Special Fin. Inc. v. Ballyrock AGS CDO 2007–1 Ltd., 452 B.R. 31, 40 (Bankr.S.D.N.Y.2011), in which Judge Peck held that, rather than exercising a right subject to the safe harbor of section 560 of the Code, the parties were impermissibly seeking to improve their positions. See also In re Lehman Brothers Holdings, Inc., 502 B.R. 383, 386 (Bankr.S.D.N.Y.2013), discussing Ballyrock and Lehman Brothers Special Fin. Inc. v. BNY Corporate Trading Services Ltd., 422 B.R. 407, 421 (Bankr.S.D.N.Y.2010).

Moreover, the rescission right sought to be exercised here is not a right automatically arising upon the commencement of the debtors' bankruptcy case and, thus, covered by section 365(e) of the Bankruptcy Code as referenced in section 555. As noted, the trustees instead seek to *de*celerate debt that was automatically accelerated under Section 6.02 of the indentures upon the bankruptcy filing. Thus, the exercise of the rescission right does not fall within the plain language of section 555 of the Code.

I have also concluded, in large measure based upon the AMR case, that relief from the automatic stay should not be granted here under section 362(d) of the Bankruptcy Code. The Second Circuit in AMR affirmed Judge Lane's determination in the exercise of his discretion not to lift the automatic stay to permit a similar notice to be sent. 730 F.3d at 111–12.

The trustees argue for stay relief under both sections 362(d)(1) and (d)(2) of the Code. I conclude that subsection (d)(2) is not applicable here. It provides for “relief from the stay provided under subsection (a) of this section with respect to a stay of an act against property under subsection (a) of this section if (A) the debtor does not have an equity in such property; and (B) such property is not necessary to an effective reorganization.” Here, the debtors convincingly argued that subsection 362(d)(2) was intended to address, and does, by its terms, address, acts against property in which a creditor has an interest, such as a lien interest, as opposed to a right against a contract or to exercise a right under a contract, such as under Section 6.02 of the indentures. See In re Motors Liquidation Company, 2010 U.S. Dist. LEXIS 125182, at *8–9 (S.D.N.Y. Nov. 17, 2010).

Moreover, under section 362(g) of the Code, the movant has the burden to show that the debtor does not have an equity in such property under section 362(d)(2)(A), and I believe that it was conceded during oral argument, and, in any event, I so find, that the first and 1.5 lien trustees have not sustained that burden. It is not clear to me how they possibly could have shown that the debtors have no equity in the indentures, given that, before a rescission the trustees' claims pursuant to the indentures are worth far less, perhaps $200 million less, than if the trustees obtain relief from the stay for rescission. That $200 million would establish, I believe, the debtors' equity in light of the fact that the trustees do not have a lien on or other prior interest in the indentures.

That leaves the trustee's request for relief under section 362(d)(1) of the Bankruptcy Code, which provides for relief from the automatic stay “for cause, including a lack of adequate protection of an interest in property of such party-in-interest.” As noted, we are not dealing with a lien or other prior interest

in property held by the indenture trustees; we are dealing with their desire to exercise a contract right, rescission. Therefore, the Second Circuit's Sonnax case, which applies generally where relief from the stay is sought for purposes other than to enforce an interest in property, controls. In re Sonnax Industries, 907 F.2d 1280, 1285–86 (2d Cir.1990) (setting forth factors that may be relevant to a determination on a request to lift the automatic stay in such circumstances); see also In re Bogdanovich, 292 F.3d 104, 110 (2d Cir.2002). AMR applied the Sonnax factors in this context. 730 F.3d at 111–12.

***23** As I noted earlier, the sending of a rescission, or deceleration notice significantly impacts the debtors' estate and creditors—in this case by enhancing claims potentially by hundreds of millions of dollars. It is, therefore, the type of action that courts have routinely refused to permit under section 362(d)(1) of the Bankruptcy Code. As noted by Judge Beatty in In re Solutia, 379 B.R. at 488, a contractual acceleration provision goes well beyond the acceleration that occurs as a matter of bankruptcy law with respect to the determination of claims against the estate. One can, as discussed in In re Solutia; In re Manville Forests Products Corp., 43 B.R. 293, 297–98 (Bankr.S.D.N.Y.) and HSBC Bank USA v. Calpine Corp., 2010 U.S. Dist. LEXIS 96792, at *10–11, observe that as a matter of law the filing of the bankruptcy case itself accelerates debt. However, a *contractual* acceleration provision advances the maturity date of the debt in ways that have consequences in the bankruptcy case beyond the operation of this general bankruptcy law principle. For example, such acceleration may give rise to a right to damages under section 1124(2)(C) of the Bankruptcy Code if the debtor later attempts to decelerate and reinstate the debt. It also may give the creditor a right to a different type or amount of interest; and the presence or absence of such a provision may also affect rights against other parties including co-debtors. See, e.g., In re Texaco, Inc., 73 B.R. 960 (Bankr.S.D.N.Y. 1987). In that case, because there was no automatic contractual acceleration provision, noteholders sought to send an acceleration notice that would give them the right to an increased interest rate under their agreement. The court declined to lift the automatic stay. Id. at 968, stating that the noteholders sought more than simply to preserve the prepetition status quo. See also In re Metro Square, 1988 Bankr.LEXIS 2864, at *7–9 (Bankr.D.Minn., August 10, 1988). And, as noted, by Judge Lifland in In re Manville Forest Products, 43 B.R. at 298 n.5, "While the Court today holds that sending a notice of acceleration is unnecessary to file a claim against a debtor for the entire amount of the debt, despite the actual maturity date or the terms of the contract, this does not apply where notice is required as a condition precedent to establish other substantive contractual rights such as the right to receive a post-default interest rate. In that case, the sending of such notice would be ineffective under the automatic stay provisions of the Code if done without the provision of the bankruptcy court." Of course, Judge Lane performed a similar analysis in denying the trustee's request for stay relief in In re AMR Corp., 485 B.R. 279, 295–96 (Bankr.S.D.N.Y.2013), aff'd 730 F.2d at 111–12.

Thus, the first and 1.5 lien trustees' request for stay relief should not be granted to permit such a material change to be effectuated. Key "Sonnax factors" regarding the impact of rescission and deceleration on the parties and on the case strongly argue against granting such relief. Therefore, in the exercise of my discretion under section 362(d)(1) of the Code, I conclude that the automatic stay should not be lifted to enable the resurrection of a make-whole claim by means of the rescission of the automatic acceleration provided for in Section 6.02 of the indentures.

As previously noted, the holders of the first and 1.5 lien notes have voted as classes to reject confirmation of the debtors' chapter 11 plan. The plan otherwise meets, as I've stated, the confirmation requirements of section 1129(a) of the Bankruptcy Code. But, to be confirmed over the objection of the objecting classes comprising the first and 1.5 lien holders, the plan must also satisfy the "cram down" requirements of section 1129(b) of the Bankruptcy Code. At issue is whether section 1129(b)(2) of the Code has been satisfied, there being no objection to the cramdown requirements pertaining to secured creditors set forth in section 1129(b)(1) with the exception of its requirement that the a plan be "fair and equitable," which term is defined in section 1129(b)(2).

Section 1129(b)(2) of the Bankruptcy Code states, "For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements: (A) With respect to a class of secured claims, the plan provides—(i)(I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and (II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property."

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Section 1129(b)(2)(A)(ii) and (iii) set forth two other ways under which a plan can be "fair and equitable" to a dissenting secured class, but neither is applicable here, the debtors relying, instead, on section 1129(b)(2)(A)(i).

The only issue as to whether the debtors' chapter 11 plan satisfies section 1129(b)(2)(A)(i) of the Code is whether the plan provides, as set forth in sub-clause (A)(i)(II), that the holders of the first and 1.5 lien notes will "receive on account of such claim deferred cash payments totaling the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property." (Sub-clause (A)(i)(I) is satisfied because under the plan the first and 1.5 lien holders shall retain the liens securing their claims to the extent of their allowed secured claims. Their liens are not being diminished under the plan, and, as I have previously found, those liens will secure the allowed amount of their claims.)

***24** Whether the plan satisfies section 1129(b)(2)(A)(i)(II) of the Code depends on the proper present value interest rate under the replacement notes to be issued to the first and 1.5 lien holders under the plan on account of their allowed claims, given that those notes will satisfy their claims over seven and seven-and-a-half years, respectively. The debtors contend that the interest rates under the 13 replacement notes are sufficient on a present value basis to 14 meet the test of section 1129(b)(2)(A)(i)(II).

The interest rate on the new replacement first lien notes that are proposed to be issued under the plan is the seven-year Treasury note rate plus 1.5 percent. As of August 26, 2014, the date of my bench ruling, that would equal an approximately 3.60 percent interest rate, based on public data issued for such Treasury notes. The proposed replacement notes for the 1.5 lien holders would have an interest rate equal to an imputed seven-and-a-half-year Treasury note (based on the weighted averaging of the rates for seven-year and ten-year Treasury notes) plus 2 percent, which as of August 26, 2014 I calculated as approximately 4.09 percent based on public data for such Treasury notes.

The indenture trustees for the first and the 1.5 lien holders contend that those rates do not satisfy the present value test in section 1129(b)(2)(A)(i)(II) of the Code and argue for higher interest rates under the replacement notes based on their view of what market-based lenders would expect for new notes if the same tenor issued by comparable borrowers.

The Court clearly is not writing on a blank slate on this issue. It is largely governed by the principles enunciated by the plurality opinion in Till v. SCS Credit Corp., 541 U.S. 465 (2004), and, to the extent that the Court has any concerns based on Till being a plurality opinion, In re Valenti, 105 F.3d 55 (2d Cir.1997).

Both of those cases analyzed and applied a closely analogous provision in chapter 13 of the Bankruptcy Code, section 1325(a)(5)(B)(i)(II), which states that, among other things required to confirm a plan with respect to an allowed secured claim, the plan must provide that, "the value, as of the effective date of the plan, of property to be distributed under the plan on account of such claim is not less than the allowed amount of such claim." As noted by the Court in Till, this provision is not only closely analogous to other provisions of the Bankruptcy Code (including section 1129 (b)(2)(A)(i)(II) that I have just quoted), but also "Congress likely intended bankruptcy judges and trustees to follow essentially the same approach when choosing an appropriate interest rate under any of the many Code provisions requiring a court to discount a stream of deferred payments back to their present dollar value." 541 U.S. at 474. Valenti, which was cited favorably in Till and which applies generally the same approach as Till to the proper present value interest rate for chapter 13 plan purposes, has also been construed as applying in a chapter 11 context to the cramdown of a secured creditor under section 1129(b)(2)(A)(i)(II). In re Marfin Ready Mix Corp., 220 B.R. 148, 158 (Bankr.E.D.N.Y. 1998). As discussed later, there is no sufficiently contrary basis to distinguish the chapter 13 and chapter 11 plan contexts in light of the similarity of the language of the two provisions and the underlying present value concept that Till recognized should be applied uniformly throughout the Code.

***25** Till and Valenti establish key first principles that I should follow, therefore, when considering the proper interest rate to present value a secured creditor's deferred distributions under a plan for cramdown purposes. Both cases quite clearly rejected alternatives that were proposed, and have been proposed now by the first and 1.5 lien trustees, that require a market-based analysis or inquiry into interest rates for similar loans in the marketplace. That is, both cases rejected the so-called "forced loan" or "coerced loan" approach, which Valenti defined as adopting the "interest rate on the rate that the creditor charges for loans of similar character, amount, and duration to debtors in the same geographic region." 105 F.3d at 63. See Till, 541 U.S. at 477, where the Court

rejected market-based methodologies in favor of the so-called "formula approach":

> [We] reject the coerced loan, presumptive contract rate, and cost of funds approaches. Each of these approaches is complicated, imposes significant evidentiary costs, and aims to make each individual creditor whole rather than to ensure the debtor's payments have the required present value. For example, the coerced loan approach requires bankruptcy courts to consider evidence about the market for comparable loans to similar (though nonbankrupt) debtors —an inquiry far removed from such courts' usual task of evaluating debtors' financial circumstances and the feasibility of their debt adjustment plans. In addition, the approach overcompensates creditors because the market lending rate must be high enough to cover factors, like lenders' transaction costs and overall profits, that are no longer relevant in the context of court-administered and court-supervised cramdown loans.

541 U.S. at 477. See also In re Valenti, 105 f.3d at 63–4, (rejecting forced loan approach in favor of a formula approach). Of course the so-called "presumptive contract rate," that Till rejected was also a market-based test based on the parties' prepetition interest rate as adjusted for current market factors, as, in lesser degree, was the "cost of funds" approach that Till also rejected, which was based on the creditor's cost of capital, again tracking a market, although, in that case, with the emphasis on the creditor's characteristics rather than the debtor's.

Both courts stated similar reasons for rejecting market-based approaches in setting a cramdown rate. As stated in Valenti, "the 'forced loan' approach misapprehends the 'present value' function of the interest rate. The objective of Section 1325(a)(5)(B)(ii) is to put the creditor in the same economic position it would have been in had it received the value of its allowed claim immediately. The purpose is *not* to put the creditor in the same position that it would have been in had it arranged a 'new' loan." (Emphasis in the original). 105 F.3d at 63–4. "Moreover, as our analysis in the preceding section illustrates, the value of a creditor's allowed claim does not include any degree of profit. There is no reason, therefore, that the interest rate should account for profit." Id. at 64. Similarly, Till distinguished the cramdown rate from market loans; the former does not require the lender to be indifferent compared to the result in a foreclosure, where the creditor could then re-lend the proceeds in the marketplace, 541 U.S. at 476, and should not "overcompensate[ ] creditors because the market lending rate must be high enough to cover factors, like lenders' transaction costs and overall profits, that are no longer relevant in the context of court-administered and court-supervised cramdown loans." Id. 541 U.S. at 477–78.

The cramdown rate analysis, therefore, should focus on a rate that does not take market factors into account but, rather, starts with the riskless rate applicable to all obligations to be paid over time, adjusted for the risks unique to the debtor in actually completing such payment. Id. 541 U.S. at 474–80. It should thus be a relatively simple, uniform approach consistent with bankruptcy "courts' usual task of evaluating the feasibility of their debt adjustment plans" not on costly and expensive evidentiary hearings to discern marketplace data. Id. 541 U.S. at 477; see also In re Valenti, 105 F.3d at 64.

***26** As noted, in light of the foregoing considerations the Supreme Court adopted, as did the Second Circuit in Valenti before it, a formula approach, which is also the approach adopted by the debtors (in contrast to the trustees for the first and 1.5 lien holders, who have utilized a market-based approach) with respect to the replacement notes to be issued under the plan. Under the formula approach, the proper rate for secured lenders' cramdown notes begins with a risk-free base rate, such as the prime rate used in Till, or the Treasury rate used in Valenti, which is then adjusted by a percentage reflecting a risk factor based on the circumstances of the debtor's estate, the nature of the collateral security and the terms of the cramdown note itself, and the duration and feasibility of the plan. Till, 541 U.S. at 479; Valenti, 104 F.3d at 64. Both Till and Valenti held that, generally speaking, the foregoing risk adjustment should be between 1 and 3 percent above the risk-free base rate. Id.

It is clear from those opinions that the formula approach's risk adjustment is not a back door to applying a market rate. Indeed, the Supreme Court stated, "We note that if the Court could somehow be certain a debtor would complete his plan, the prime rate would be adequate to compensate any secured creditors forced to accept cramdown loans." 541 U.S. at 479 n.18. That is, no adjustment whatsoever to the risk-free rate

would be required if the Court found that the debtors were certain to perform their obligations under the replacement notes. The focus, therefore, should be generally on the risk posed by the debtor within a specified band, as opposed to market rates charged to comparable companies. Nothing could be clearer than the two Courts' statements on that point. Therefore, as a first principle, the cramdown interest rate, under section 1129(b)(2)(A)(i)(II) of the Code, should not contain any profit or cost element, which were rejected by Till and the Second Circuit in Valenti as inconsistent with the present-value approach for cramdown purposes. In addition, market-based evidence should not be considered, except, arguably and, if so secondarily, when setting a proper risk premium in the formula approach taken by Till and Valenti.

Notwithstanding this very clear guidance, some courts, and the first and 1.5 lien trustees here, have argued that a market rate test should nevertheless be followed in chapter 11 cases. They have relied, as they must since there is no other basis in Till or Valenti for the argument, entirely on footnote 14 in Till, which appears at 541 U.S. 476.

That footnote states, "This fact helps to explain why there is no readily apparent Chapter 13 cramdown market rate of interest. Because every cramdown loan is imposed by a court over the objection of a secured creditor, there is no free market of willing cramdown lenders. Interestingly, the same is *not* true in the Chapter 11 context, as numerous lenders advertise financing for Chapter 11 debtors-in-possession." (Emphasis in the original.)

Till's footnote 14 then cites certain web site addresses that advertise such financing, and continues, "Thus, when picking a cramdown rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce. In the Chapter 13 context, by contrast, the absence of any such market obligates courts to look to first principles and ask only what rate will fairly compensate a creditor for its exposure."

I have the following reactions to that discussion. First, as is clear from its introductory clause, Till's footnote 14 is referring to a specific fact alluded to in the sentence to which it is footnoted, which is that the cramdown rate of interest does not "require that the creditors be made subjectively indifferent between present foreclosure and future payment," that is, between future payment under the plan and how the creditor would put its money to use lending to similar borrowers after a foreclosure in the marketplace. Id. And then the Court says, "Indeed the very idea of a cramdown loan *precludes* the latter result: By definition, a creditor forced to accept such a loan would prefer instead to foreclose." (Emphasis in the original.) Therefore, footnote 14's statement that "this fact helps to explain why there is no readily apparent Chapter 13 cramdown market rate of interest," is referring to a willingness to lend to a debtor in bankruptcy but does so in a context that very clearly rejects the lender's right or to be rendered indifferent to cramdown or to be compensated for cramdown purposes on a market basis. More specifically, footnote 14 refers to debtor-in-possession financing, where third parties seek to lend money to a debtor and the debtor seeks to borrow it, in contrast to opposing the debtor's forced cramdown "loan."

***27** (As an aside, I should note that Till has been criticized for its understanding of debtor-in-possession, or "DIP" loans, and I believe no case has suggested that a DIP loan rate should be used as the rate for a cramdown present-value calculation. The criticism is found in 7 Collier on Bankruptcy, paragraph 1129.05[c][i] (16th ed.2014), where the editors state, "The problem with this suggestion"—i.e., footnote 14's reference to DIP loans—"is that the relevant market for involuntary loans in Chapter 11 may be just as illusory as in Chapter 13. The reason for this illusion is the inapt and unstated inference the Court makes with respect to the similarity between the interest rates applicable to debtor-in-possession financing and the interest rates applicable to loans imposed upon dissenting creditors at cramdown. While both types of financing can occur in a Chapter 11 case, that may be the extent of their similarity. Debtor-in-possession financing occurs at the very beginning of the case, while the determination of a cramdown rate, under Section 1129(b)(2), occurs at confirmation. Thus, instead of the interim and inherently more uncertain risk present in debtor-in-possession financing, the court, at confirmation, is presented with a less risky, more stable and restructured debtor. The fact that the debtor is more stable is bound up in the court's necessary feasibility determination under Section 1129(a)(11). In addition, common risk factors, such as the loan's term and the level of court supervision, differ greatly between the two types of financing. There are many more differences, but they can be summed up as follows: loans imposed at confirmation resemble more traditional exit or long-term financing than interim debtor-in-possession financing.")

Thus it was not general financing in the marketplace that Till was focusing on in footnote 14, because, again, it was describing loans that lenders *want* to make to the debtor itself, not loans that they could make with the proceeds

of a foreclosure or in the marketplace to similarly situated borrowers. This is made clear by footnote 15 in Till, as well as footnote 18 that I previously quoted. Footnote 15 states that the Court disagrees with the district court's coerced loan approach, which "aims to set the cramdown interest rate at the level the creditor could obtain from new loans of comparable duration and risk." 541 U.S. at 477 n.15. Moreover, as noted before, the Court actually contemplated, in footnote 18, literally no premium on top of the risk-free rate if it could be determined with certainty that the debtor would complete the plan. Id. 541 U.S. at 479 n.18.

In addition, there clearly was some form of market for automobile loans to debtors like the debtors in the Till case. That market, in fact, had a lot of data behind it. Id. 541 U.S. at 481–82; 495 n.3 (dissenting opinion). Nevertheless, the Court felt constrained to refer to it as not a "perfectly competitive market," Id. 541 U.S. at 481, for which Justice Scalia's dissent somewhat berated the plurality. Id. 541 U.S. at 494–95. Indeed, based on my experience reviewing hundreds, if not thousands, of reaffirmation agreements and other matters involving auto loans, there are and always have been active markets for such loans, just as the value of cars and trucks is tracked in readily accessible market guides. Put differently, there are far more lenders and borrowers for auto loans, with access to more public data, than lenders and borrowers with respect to DIP or exit financing in chapter 11 cases. In this case, for example, the evidence shows that there were only three available exit lenders to the debtors, who eventually combined on proposed backup takeout facilities while seeking to keep confidential their fees and rate flex provisions.

This reality, as well as the fact that the plurality in Till felt the need discount less than a "perfectly competitive market," underscores, along with the rest of the opinion, that footnote 14 is a very slim reed indeed on which to require a market-based approach in contrast to every other aspect of Till. Certainly there is no meaningful difference between the chapter 11, corporate context and the chapter 13, consumer context to counter Till's guidance that courts should apply the same approach wherever a present value stream of payments is required to be discounted under the Code. Id. 541 U.S. at 474. The rights of secured lenders to consumers and secured lenders to corporations are not distinguished in Till, nor should they be. Nor does the relative size of the loan or the value of the collateral matter under Till's footnote 14, as it should not. Till does state that a chapter 13 trustee supervises the debtor's performance of his or her plan, id. 541 U.S. at 477; however, with replacement notes overseen by an indenture trustee for sophisticated holders, there will at least be comparable supervision under the debtors' plan, particularly in a district like this where secured claims often are paid "outside" of chapter 13 plans and, therefore, the chapter 13 trustee will not know whether the debtor has defaulted on the secured debt post-confirmation.

***28** In sum, then, footnote 14 should not be read in a way contrary to Till and Valenti's first principles, which are, instead of applying a market-based approach, a present value cramdown approach using an interest rate that takes the profit out, takes the fees out, and compensates the creditor under a formula starting with a base rate that is essentially riskless, plus up to a 1 to 3 percent additional risk premium, if any, at least as against the prime rate, for the debtor's own unique risks in completing its plan payments coming out of bankruptcy.

As I've stated, certain courts, nevertheless, have required a two-step approach, that is, first inquiring whether there is an efficient market, not for DIP loans, but for financing generally for borrowers like the debtor, and only if there is no such market, applying the formula approach as set forth in Till and Valenti.

The leading case taking this approach is In re American HomePatient, Inc., 420 F.3d 559 (6th Cir.2005), cert. denied, 549 U.S. 942 (2006). It is clear from that case, however, that prior to Till the Sixth Circuit, in contrast to the Second Circuit, had applied the coerced-loan method, id. at 565–66, and then concluded that, given that Till was not on all fours, it should continue to apply the coerced-loan approach unless there was no efficient market. Id. at **568**. This is, of course, in contrast to this Court's duty to follow the guidance offered by Valenti, as well as Till.

Other courts applying American HomePatient's two-step approach include Mercury Capital Corp. v. Milford Connecticut Associates, L.P., 354 B.R. 1, 11–2 (D.Conn.2006) (remanding to the bankruptcy court to make an efficient market rate analysis); In re 20 Bayard Views LLC, 445 B.R. 83 (Bankr. E.D.N.Y.2011) (undertaking, after an eleven-day trial, a market analysis before concluding that there was no efficient market for Till purposes, and then applying the Till formula approach); and In re Cantwell, 336 B.R. 688, 692–93 (Bankr.D. N.J.2006) (applying Till formula approach in the absence of "an efficient market").

I conclude that such a two-step method, generally speaking, misinterprets Till and Valenti and the purpose of section 1129(b)(2)(A)(i)(II) of the Code based on the clear guidance of those precedents.

Further, as noted by the Fifth Circuit in In re Texas Grand Prairie Hotel Realty, L.L.C., 710 F.3d 324 (5th Cir. 2013), the first step of the two-step approach is almost, if not always, a dead end. As that decision observed, the vast majority of cases have ultimately applied a Till prime-plus approach or base rate-plus approach to the chapter 11 cramdown rate, either having spent considerable time determining that there is no efficient market or simply by moving to the base-rate-plus formula in the first instance. Id. at 333–34 (citing cases). This should not be surprising because it is highly unlikely that there will ever be an efficient market that does not include a profit element, fees and costs, thereby violating Till and Valenti's first principles, since capturing profit, fees and costs is the marketplace lender's reason for being. That is, as acknowledged by counsel for the trustees in oral argument, market lenders need to be rewarded, or to receive a profit. (Moreover, the two-step approach has a perverse underpinning: if the debtor is healthy enough to correspond to borrowers who could receive comparable loans in the marketplace, it would in all likelihood have to pay a higher cramdown rate than under the Till and Valenti formula approach for debtors who could not obtain a comparable loan in the market.)

***29** The indenture trustees nevertheless argue that the debtors' case is unique, or at least highly unusual, in that the debtors have substantially contemporaneously with confirmation obtained backup loan commitments to fund the cash-out alternative if the first lien and 1.5 lien holder classes had voted to accept the plan. Specifically the debtors obtained commitments for a $1 billion first lien backup takeout facility and a bridge facility of $250 million. Those commitments provide for higher rates than the replacement notes under the plan for the first and the 1.5 lien holders.

For the committed first lien backup takeout facility, the rate is LIBOR plus 4 percent, with a floor for LIBOR of 1 percent. Because LIBOR is, at this time, approximately .15 percent, effectively this would be a five percent rate. (There is also an alternative base rate for this facility that, given today's prime rate of approximately 3.25 percent, would be 6.25 percent, which is, however, exercisable at the debtors' option.) The committed bridge facility provides for a rate of LIBOR plus 6 percent, increasing in .5 percent increments every three months, to a capped amount. It appears relatively clear that the debtors intend, if rates remain low, to take out that facility before it increases precipitously.

The trustees have argued that these backup takeout loans should be viewed as proxies for the Till formula rate, even though—or, according to the trustees, because—they are based on a market process, albeit one, as discussed above that was relatively opaque and involved only three lenders who ultimately combined to provide the commitments on a semi-confidential basis.

Again, however, I believe that the trustees are misreading Till and Valenti in their emphasis on the market. In addition, it is clear to me that no private lender, including the lenders who the debtors have obtained backup takeout commitments from, would lend without a built-in profit element, let alone recovery for costs and fees, which also, as discussed above, is contrary to Till and Valenti's first principles and the purpose of section 1129(b)(2)(A)(i)(II).

The indenture trustees state that I should assume that all of the back-up lenders' profit is subsumed in the upfront fees that are to be charged under the agreements, as well as an availability fee, but they have not offered any evidence or rationale for that proposition I decline to assume that there is no profit element in the backup facilities' rates. The trustee also have offered no evidence of any profit element that could be backed out of the back-up loans. Therefore, I'm left with the conclusion that there is, in fact, a profit element which is unspecified and unquantified in the backup loans, which, therefore, makes these two loans, even if I were to accept a market-based approach, at odds with Till and Valenti, as well as the courts that have followed Till in the absence of any clear market for coercive loans and those courts that have that followed Till or Valenti in a chapter 11 context without considering markets at all, including In re Village at Camp Bowie I LP, 454 B.R. 702, 712–13 (Bankr.N.D.Tex.2011); In re SW Boston Hotel Venture, LLC, 460 B.R. 38, 56 (Bankr.D. Mass.2011); In re Lilo Props., LLC, 2011 Bankr.LEXIS 4407, at *3–6 (Bankr.D.Vt. Nov. 4, 2011); and In re Marfin Ready Mix Corp., 220 B.R. at 158.

I conclude, therefore, that Till and Valenti's formula approach is appropriate here, that is, that the debtors are correct in setting the interest rates on the first and 1.5 lien replacement notes premised on a base rate that is riskless, or as close to riskless as possible, plus a risk premium in the range of 1 to 3

percent, if at all, depending on the Court's assessment of the debtors' ability to fully perform the replacement notes.

***30** The first and 1.5 lien trustees have next challenged the debtors' analysis of the risk premium. As noted, that risk premium for the first lien replacement notes is 1.5 percent on top of the seven-year Treasury note rate, and with respect to the replacement notes for the 1.5 lien holders, it is 2 percent on top of an imputed seven-and-one-half-year Treasury note rate. I believe that, in light of the factors to be considered when deciding the proper risk premium under the Till and Valenti formula approach, namely, the circumstances of the debtors' estate, the nature of the security (both the underlying collateral and the terms of the new notes), and the duration and feasibility of the reorganization plan, the debtors have also performed a proper analysis of the risk premium.

The record on this issue consists primarily of the declaration and testimony of Mr. Carter (the debtor's CFO), the he expert reports and testimony of Mr. Derrough (the debtors' investment banker), and the expert reports and testimony of Mr. Augustine (the first lien trustee's investment banker) and the expert reports of Mr. Kearns (the 1.5 lien trustee's investment banker).

The only meaningful analysis of the debtors' underlying economic condition and the only projections were those undertaken by the debtors in the process testified to by Mr. Carter and Mr. Derrough. I conclude that such analysis and projections resulted from a rigorous process based upon the debtors' bottoms-up, as well as top-down, budgeting activity for 2014, as well as the debtors' actual results for 2013. The process benefitted, I believe substantially, from the input not only of Mr. Derrough and his team at Moelis, but also from testing by the debtors' future shareholders, including the members of the ad hoc committee of second lien holders and Apollo, who have committed, with others, to invest $600 million of equity in the reorganized debtors under the plan, in addition to agreeing to receive only equity on account of their notes.

Although there was considerable kibbitzing by Messrs. Augustine and Kearns regarding the debtors' projections, they engaged in no independent testing of them. Nor did they engage in a rigorous testing of those projections other than to point out that in the past eight of nine years the debtors have missed their projections, sometimes materially. Those eight or nine years of projections did not have the benefit of vetting by Moelis and the second lien holders, however, that I have discussed. Nor have Messrs. Augustine and Kearns conducted a valuation of the collateral or of the debtors as a going concern, accepting, essentially, the debtors' valuations.

In addition, it was pointed out that the debtors have missed their projections for the first quarter of this case, where there was input from, I can assume, independent third parties interested in making sure the projections were accurate. However, I found credible Mr. Carter's testimony on this point (as I found Mr. Carter generally credible), which was that those downward results for the post-bankruptcy period were largely attributable to the effects of the bankruptcy case, which would be ameliorated if not ended by the debtors' emergence from bankruptcy and re-regularization of customer and supplier relationships.

As far as the analysis is concerned, the post-bankruptcy collateral coverage for the first and 1.5 lien replacement notes is substantially better than the coverage in the Till case. Even with a twenty percent variance for each of the five years of the debtors' projections, it appears clear that the replacement notes would be repaid in full, particularly given the fact that I have found that there will be no make-whole amount included in the principal amount of the loans. Here, the first and 1.5 lien holders' new collateral coverage, unlike in Till (where it was one-to-one, the debt equaling the current value of the collateral, 541 U.S. at 470), and unlike in In re 20 Bayard Views (where it also was one-to-one with considerable execution risk, 445 B.R. at 112), has a large cushion. Here, the debt under the replacement notes is approximately 50 to 75 percent less than the value of the collateral therefor, and closer to 50 percent than 75 percent. Gross debt leverage also will substantially decrease under the plan, from 17.8 percent to 5.6 percent, or from $4.4 billion in debt down to $1.3 billion.

***31** In light of those considerations, as well as the telling fact that there is a committed $600 million equity investment under the plan, one can assume that, in the nature of risk for debtors emerging from bankruptcy, the 1.5 and 2 percent factors chosen by the debtors are appropriate.

In response, the first and 1.5 lien trustees have not carried their burden to show why those risk premiums are too low. First, in proposing their alternative risk premiums their under the twenty percent per year down-side projection scenario that Mr. Derrough ran, instead taking, in effect, a one-time leverage snapshot at its peak.

Mr. Kearns, although not taking as many liberties as Mr. Augustine, only focused on collateral leverage while ignoring the $600 million equity investment and total debt leverage.

Both experts for the first and 1.5 lien trustees also referred to rates of default for notes on a market basis that are rated, as they believe the replacement notes would be rated, at B2B or B and referred to defaults of, in Mr. Kearns' case, 34 percent in respect of such securities. They did not analyze, however, the difference between default and recovery rates. Clearly, the risk of default is an important risk to consider in this type of analysis, but the more important risk is the ultimate risk of non-payment (for example, notwithstanding the debtors' bankruptcy, there is sufficient committed backup takeout financing to pay the first and 1.5 lien holders' allowed claims in full in cash), which is where collateral coverage and total debt leverage come into play and 21 support the debtors' analysis.

The experts for the first and 1.5 lien trustees have also complained about the duration of the notes, although the first lien replacement note's seven-year term is, in essence, the remaining term of the present first lien notes, and the risk differential attributable to the 1.5 lien replacement notes' seven-and-a-half year maturity in Mr. Kearns' chart is de minimis.

I also believe that once one takes out fees such as pre-payment fees and other costs and similar covenants, the covenants in the replacement notes for the first and the 1.5 lien holders are not materially different on an economic basis from the covenants in the proposed backup takeout facilities.

Consequently, applying a formula of prime plus 1 to 3 percent, as I believe is appropriate under Till and Valenti unless there are extreme risks that I believe do not exist here, a risk premium of 1.5 and 2 percent, respectively, for the two series of replacement notes is appropriate.

There is one point, however, on which I disagree with the debtors' analysis. The debtors, consistent with Valenti, 105 F.3d at 64, and the well-reasoned Village at Camp Bowie case, 454 B.R. at 712–15, chose as their base rate the applicable or imputed Treasury note rate. It was appropriate for them to do this, rather than blindly following the prime rate used in Till. The Treasury note rate actually is, as both Mr. Kearns and Mr. Derrough testified, often used as a base rate for longer-term corporate debt such as the replacement notes. The prime rate may, on the other hand, be a more appropriate base rate for consumers, although Valenti chose the Treasury rate, instead, perhaps because such loans are considered to be essentially riskless. Both rates of course are easily determinable. But the Treasury rate, as confirmed by all three experts, does not include *any* risk, given that the United States government is the obligor, whereas an element of risk is inherent in the prime rate, which strongly correlates to the interest rate banks charge each other on overnight interbank loans and thus may reflect risks seen in banks' financial strength, of stronger concern during the last few years.

***32** Given that fact, I question whether the 1 to 3 percent risk premium spread over prime used in Till would be the same if instead, as here, a base rate equal to the Treasury were used. I say this in particular under the present circumstances where the prime rate for short-term loans is materially higher than the Treasury rate for long-term loans, a somewhat anomalous result. It seems to me, then, that although the general risk factor analysis conducted by Mr. Derrough was appropriate, there should be an additional amount added to the risk premium in light of the fact that the debtors used Treasury rates as the base rate. The additional increment, I believe, should be another .5 percent for the first lien replacement notes, and an additional .75 percent for the 1.5 lien replacement notes. I believe that these adjustments adequately take into account risks inherent in the debtors' performance of the replacement notes above the essentially risk-free Treasury note base rates. Therefore, rather than being the seven-year Treasury plus 1.5 percent, equaling 3.6 as of August 26, 2014, the rate for the first lien replacement notes should be the Treasury rate plus 2 percent, for an overall rate of 4.1 percent as of such date; and the rate for the 1.5 lien replacement notes should be the imputed seven-and-a-half-year Treasury note rate plus 2.75 percent, or a 4.85 rate as of August 26, 2014. This would require an amendment to the plan, obviously, and I don't know whether the necessary parties would agree to it, but I believe that they should, because it is necessary to cram down the plan over the objection of the first and 1.5 lien holder classes.

That leaves one remaining issue, which is the confirmability of the plan in light of the plan's third-party release and injunction provisions. Those provisions have not been objected to except for the first and 1.5 lien trustees' objection to the inclusion of third-party releases for parties named or identified in state court lawsuits brought by the first and 1.5 lien trustees to enforce the terms of the Intercreditor Agreement on the second lien holders. (Those lawsuits have been removed to this Court, although remand motions are

pending.) The second lien holder third parties covered by the plan's release and injunction provisions are referred to here as the "Released Second Lienholders").

While it is true that third-party releases and related injunctions in Chapter 11 plans and confirmation orders are, under the law of the Second Circuit, proper only in rare cases, see Deutsche Bank AG v. Metromedia Fiber Network, Inc., 416 F.3d 136, 141 (2d Cir.2005), if they are consensual or are not objected to after proper notice, courts generally approve them unless they are truly overreaching on their face. I do not find anything truly offensive in these releases and, thus, to the extent that they have not been objected to or a party voted in favor of the plan or did not opt out notwithstanding the clear notice in the ballot that stated, in upper-case letters, "If you voted to reject the plan and you did not opt out of the release provisions by checking the box below, or if you voted to accept the plan regardless of whether you checked the box below, you will be deemed to have conclusively, absolutely, unconditionally, irrevocably and forever released and discharged the Released Parties from any and all claims and causes of action to the extent provided in Section 12.5 of the plan," the plan may be confirmed consistent with both Metromedia and the case law interpreting it, as summarized by Judge Lane in In re Genco Shipping & Trading, Ltd., 513 B.R. 233 (Bankr.S.D.N.Y.2014).

It is another story, however, where there is a substantial objection to a third-party release and related injunction, which is the case here, albeit that it is by a group that at least under the ruling that I just gave, would be satisfied as a matter of law by a plan that would be consistent with my cramdown ruling (which is one of the factors arguing for a release's effectiveness under the caselaw that I have cited).

Here, what was originally sought to be released included claims made by the first and 1.5 lien trustees against the Released Second Lienholders in the litigation that has been removed to this Court. In that litigation, the first and 1.5 lien trustees assert a breach claim under the Intercreditor Agreement based on the Released Second Lienholders' support of the plan and receipt of consideration under the plan before the payment to the holders of the first and 1.5 liens required by the Intercreditor Agreement, which, they contend, under the agreement's definition of "discharge of indebtedness," is payment in full, in cash.

***33** In light of comments made during the confirmation hearing regarding my concerns about the proposed release as it applied to the Released Second Lienholders, the debtors and those released parties have agreed, however, to amend the plan to carve out of the release of rights with respect to, and the discharge of, the pending litigation, provided that the Court maintains jurisdiction over that litigation.

I conclude, having evaluated the factors under Metromedia and the case law supporting third-party plan releases—and, though not fully, having reviewed the litigation claims against the Released Second Lienholders—that this modified release is appropriate and would be sustained if the plan were otherwise confirmable.

It is clearly the case that the Released Second Lienholders are providing substantial consideration under the plan. They are agreeing not to seek pari passu treatment on their deficiency claims with the trade creditors (that is, all creditors with unsecured claims with the exception of the senior subordinated unsecured noteholders), who are being paid in full under the plan.

They are also committing to underwrite the $600 million equity investment under the plan. They have also supported confirmation of the plan starting with executing a prepetition plan support agreement (although I agree with Judge Lane's conclusion in Genco Shipping & Trading that one cannot bootstrap a plan support agreement containing an indemnification right into consideration for a third-party release under a plan).

I also believe that the third-party release is an important feature of this plan. Counsel for the indenture trustees, in essence, asked me to play a game of chicken with the Released Second Lienholders (beyond my comments that led to the on-the-record amendment of the release) to see if they actually would withdraw their support of the plan if the plan and confirmation order were not reasonably satisfactory to them, by requiring the full deletion of the release, but I'm not prepared to do that. I believe that, instead, I can assess the likelihood that the Released Second Lienholders would walk as well as Mr. Carter on behalf of the debtors did, and assume, like Mr. Carter, that there is a reasonable risk that if this release, as modified on the record, did not remain in the plan, the Released Second Lienholders would withdraw their support of the plan. This reasonable risk is especially significant, moreover, given all that the Released Second Lienholders have committed to do under the plan.

Nevertheless, I think that the released parties' substantial consideration should be weighed against, in some measure, the claims that are being asked to be released and, where they're being actively pursued, as is the case with the carved-out litigation, ensure that such claims are not frivolous or back-door attempts to collect from the reorganized debtors notwithstanding the discharge. Thus, I believe that it is appropriate to maintain jurisdiction over such litigation, as provided in the modified release, for the same reasons that Judge Gerber has discussed in a number of opinions, including In re BearingPoint, Inc., 453 B.R. 486 (Bankr.S.D.N.Y.2011), and In re Motors Liquidation Company, 447 B.R. 198 (Bankr. S.D.N.Y.2011): that, in order to be able to sort out whether a suit is, in large measure, a strike suit or looking to get a recovery from the reorganized debtor through the artifice of proceeding against a third party or, on the other hand, sets forth a genuine claim that would not be covered by the bankruptcy plan or for which there's not sufficient value being provided by the released parties, the court should, at a minimum, keep jurisdiction over the matter. This also avoids the potential for conflicting orders in different courts and the assertion in other courts of positions notwithstanding the doctrines of collateral estoppel and res judicata, which, based on oral argument, I have serious concerns over here. And I do not believe that the Released Second Lienholders or other courts should be subjected to a potentially multi-court process with respect to the pending Intercreditor Agreement litigation and enforcement of this Court's confirmation order.

***34** I also should note, because this was raised in the objection, that I firmly believe that I have jurisdiction over this issue for the reasons that I stated at the beginning of this ruling, and that I can issue a final order on it within the confines of Stern v. Marshall, given that this is in the context of the confirmation of the plan, and pertains ultimately to the debtors' rights under the Bankruptcy Code. That would hold true, even post-confirmation or with regard to a post-confirmation effect on the estate. See, for example, In re Quigley Company, 676 F.3d 45, 53 (2d Cir.2012), cert. denied, 133 C. Ct. 2849 (2013); In re Chateaugay Corp., 213 B.R. 633, 637–38 (S.D.N.Y.1997), and In re Lombard–Wall, Inc., 44 B.R. 928, 935 (Bankr.S.D.N.Y.1984).

So, were the plan to be amended as I have said I would find to be appropriate with regard to the cramdown interest rates, I would confirm the plan as it otherwise stands, including the amended release provision.

I believe that covers all of the outstanding confirmation issues. As I said before, to the extent that these issues also overlap with issues that have been raised in the three adversary proceedings covered by the confirmation procedures order, those issues have been decided at this time as well; therefore, I need an order in those proceedings, regardless of what you do with amending the plan.

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**In Re: MPM SILICONES, LLC, et al., Debtors. U.S. BANK NATIONAL ASSOCIATION, as Indenture Trustee, Appellant, v. WILMINGTON SAVINGS FUND SOCIETY, FSB, as Indenture Trustee, MOMENTIVE PERFORMANCE MATERIALS INC., MOMENTIVE PERFORMANCE MATERIALS WORLDWIDE INC., MOMENTIVE PERFORMANCE MATERIALS USA INC., JUNIPER BOND HOLDINGS I LLC, JUNIPER BOND HOLDINGS II LLC, JUNIPER BOND HOLDINGS III LLC, JUNIPER BOND HOLDINGS IV LLC, MOMENTIVE PERFORMANCE MATERIALS QUARTZ, INC., MPM SILICONES, LLC, MOMENTIVE PERFORMANCE MATERIALS SOUTH AMERICA INC., MOMENTIVE PERFORMANCE MATERIALS CHINA SPV INC., Appellees. BOKF, NA, solely as Trustee for the MPM Escrow LLC and MPM Finance Escrow Corp. 8.875% First Priority Senior Secured Notes due 2020; WILMINGTON TRUST, NATIONAL ASSOCIATION, solely as Trustee for the Momentive Performance Materials Inc. 10% Senior Secured Notes due 2020, Appellants, v. MOMENTIVE PERFORMANCE MATERIALS INC., MOMENTIVE PERFORMANCE MATERIALS WORLDWIDE INC., MOMENTIVE PERFORMANCE MATERIALS USA INC., JUNIPER BOND HOLDINGS I LLC, JUNIPER BOND HOLDINGS II LLC, JUNIPER BOND HOLDINGS III LLC, JUNIPER BOND HOLDINGS IV LLC, MOMENTIVE PERFORMANCE MATERIALS QUARTZ, INC., MPM SILICONES, LLC, MOMENTIVE PERFORMANCE MATERIALS SOUTH AMERICA INC., and MOMENTIVE PERFORMANCE MATERIALS CHINA SPV INC., Appellees.**

**14 CV 7471 (VB),14 CV 7472 (VB),14 CV 7492 (VB)**

**UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK**

**531 B.R. 321; 2015 U.S. Dist. LEXIS 66420**

**May 4, 2015, Decided**
**May 4, 2015, Filed**

**PRIOR HISTORY:** In re MPM Silicones, LLC, 2014 Bankr. LEXIS 3926 (Bankr. S.D.N.Y., Sept. 9, 2014)

**COUNSEL:** **[**1]** For MPM Silicones, LLC, In Re, Debtor (7:14-cv-07471-VB, 7:14-cv-07472-VB): James C. Dugan, LEAD ATTORNEY, Willkie Farr & Gallagher LLP (NY), New York, NY.

For U.S. Bank National Association, as indenture trustee, Appellant (7:14-cv-07471-VB, 7:14-cv-07472-VB): Susheel Kirpalani, LEAD ATTORNEY, Quinn Emanuel, New York, NY.

For Momentive Performance Materials Inc., Appellee (7:14-cv-07471-VB, 7:14-cv-07472-VB): James C. Dugan, Jennifer Jaye Hardy, Matthew A Feldman, Rachel Caroline Strickland, LEAD ATTORNEYS, Willkie Farr & Gallagher LLP (NY), New York, NY.

For Wilmington Savings Fund Society, FSB, as successor indenture trustee, Appellee (7:14-cv-07471-VB, 7:14-cv-07472-VB): Patrick Sibley, Seth Howard Lieberman, LEAD ATTORNEYS, Pryor Cashman LLP, New York, NY.

For Ad Hoc Committee of Second Lien Noteholders, Appellee (7:14-cv-07471-VB, 7:14-cv-07472-VB): Dennis F. Dunne, LEAD ATTORNEY, Milbank, Tweed, Hadley & McCloy LLP (NYC), New York, NY; Michael Lane Hirschfeld, Samuel Alfred Khalil, LEAD ATTORNEYS, Milbank, Tweed, Hadley & McCloy LLP, Los Angeles, CA.

For Apollo Management, LLC, and certain of its affiliated funds, Appellee (7:14-cv-07471-VB, 7:14-cv-07472-VB): Abid Qureshi, Deborah **[**2]** Jill Newman, Ira S. Dizengoff, LEAD ATTORNEYS, Akin Gump Strauss Hauer & Feld LLP (NYC), New York, NY; Philip Charles Dublin, LEAD ATTORNEY, Akin Gump Strauss Hauer & Feld LLP, New York, NY.

For MPM Silicones, LLC, In Re, Debtor (7:14-cv-07492-VB): James C. Dugan, Roger David Netzer, LEAD ATTORNEYS, Willkie Farr & Gallagher LLP (NY), New York, NY.

For BOKF, NA, as First Lien Trustee, Appellant (7:14-cv-07492-VB): Brian E. Greer, Mauricio Alejandro Espana, LEAD ATTORNEYS, Dechert, LLP (NYC), New York, NY; Mark Rodney Somerstein, LEAD ATTORNEY, Kelley Drye & Warren, LLP (NY), New York, NY; Michael J. Sage, LEAD ATTORNEY, Dechert LLP, New York, NY; Danielle Spinelli, Wilmer Cutler Pickering Hale & Dorr, L.L.P. (NY), Washington, DC, NW; Philip David Anker, Wilmer Cutler Pickering Hale and Dorr LLP (NYC), New York, NY; William J. Perlstein, Wilmer Cutler Pickering Hale and Dorr LLP, Washington, DC.

For Wilmington Trust, N.A., as 1.5 Lien Trustee, Appellant (7:14-cv-07492-VB): Brian James Rooder, LEAD ATTORNEY, Davis Polk & Wardwell L.L.P., New York, NY; Mark Irwin Bane, Mark Rodney Somerstein, LEAD ATTORNEYS, Kelley Drye & Warren, LLP (NY), New York, NY; Michael J. Sage, LEAD ATTORNEY, Dechert **[**3]** LLP, New York, NY; Michael Stephen Winograd, LEAD ATTORNEY, Ropes & Gray LLP (NYC), New York, NY; Philip David Anker, Wilmer Cutler Pickering Hale and Dorr LLP (NYC), New York, NY.

For Momentive Performance Materials Inc., Appellee (7:14-cv-07492-VB): Dan Cogan Kozusko, LEAD ATTORNEY, Willkie Farr & Gallagher LLP, New York, NY; James C. Dugan, Joseph Thompson Baio, Matthew A Feldman, Roger David Netzer, LEAD ATTORNEYS, Willkie Farr & Gallagher LLP (NY), New York, NY.

For Apollo Global Management LLC, Appellee (7:14-cv-07492-VB): Ira S. Dizengoff, Stephen Michael Baldini, LEAD ATTORNEYS, Akin Gump Strauss Hauer & Feld LLP (NYC), New York, NY; Philip Charles Dublin, LEAD ATTORNEY, Akin Gump Strauss Hauer & Feld LLP, New York, NY.

For Ad Hoc Committee of Second Lien Noteholders, Appellee (7:14-cv-07492-VB): Dennis F. Dunne, LEAD ATTORNEY, Milbank, Tweed, Hadley & McCloy LLP (NYC), New York, NY; Samuel Alfred Khalil, LEAD ATTORNEY, Milbank, Tweed, Hadley & McCloy LLP, Los Angeles, CA.

**JUDGES:** Vincent L. Briccetti, United States District Judge.

**OPINION BY:** Vincent L. Briccetti

**OPINION**

**[*324]** **MEMORANDUM DECISION**

Briccetti, J.:

This case involves related appeals from proceedings in the United States Bankruptcy Court for the Southern **[**4]** District of New York (Robert D. Drain, Judge), during which the Joint Chapter 11 Plan (the "Plan") of Reorganization for Momentive Performance Materials Inc. ("MPM") and its affiliated debtors (collectively with MPM, the "Debtors") was confirmed.

The Debtors filed a Chapter 11 petition on April 13, 2014. After several months of negotiations, Judge Drain held a multi-day confirmation hearing and issued a bench decision on August 26, 2014, which was later corrected and modified in a bench decision on September 9, 2014. On September 11, 2014, Judge Drain issued a written order to effectuate the bench decisions. These appeals stem from the September 9, 2014, bench decision and the September 11, 2014, written order (the "Orders").

Appellant U.S. Bank National Association ("U.S. Bank") contends the Bankruptcy Court erred in confirming the Plan despite the Plan's failure to provide any distributions to holders of subordinated notes (the "Subordinated Notes") issued pursuant to an indenture agreement dated December 4, 2006 (the "2006 Indenture").

Appellants BOKF, N.A., and Wilmington Trust, National Association, contend the Bankruptcy Court chose the wrong cramdown interest rate and erred in **[**5]** confirming the Plan despite the Plan's failure to provide a "make-whole" payment to holders of senior lien notes issued pursuant to indentures dated May 25 and October 25, 2012 (the "2012 Indentures").

For the following reasons, the Bankruptcy Court's Orders are AFFIRMED.

The Court has subject matter jurisdiction pursuant to 28 U.S.C. § 158(a).

**BACKGROUND**

MPM, together with its Debtor and non-Debtor subsidiaries (collectively, the "Company"), is one of the world's largest producers of silicones and silicone derivatives, which are used in the manufacture of a myriad of industrial and household products. The Company began as the Advanced Materials business of General Electric Company ("GE"). In 2006, investment funds affiliated with Apollo Global Management, LLC (collectively, "Apollo"), acquired the Company from GE.

I. Facts Leading up to Bankruptcy

At the time Apollo acquired the Company, the Debtors issued substantial debt obligations, including the Subordinated Notes. The Subordinated Notes were issued pursuant to the 2006 Indenture,[1] **[*325]** which describes the relative ranking of the Subordinated Notes in comparison with other debt obligations issued by the Debtors. The 2006 Indenture provides that the Subordinated **[**6]** Notes are "subordinated in right of payment . . . to the prior payment in full of all existing and future Senior Indebtedness of the Company." (U.S. Bank Ex. D, § 10.01). Senior Indebtedness is defined, in relevant part, as:

> all Indebtedness . . . unless the instrument creating or evidencing the same or pursuant to which the same is outstanding expressly provides that such obligations are subordinated in right of payment to any other Indebtedness of the Company[;] [the "Base Definition"] . . . provided, however, that Senior Indebtedness shall not include, as applicable:
>
> 4) any Indebtedness or obligation of the Company . . . that by its terms is subordinate or junior in any respect to any other Indebtedness or obligation of the Company . . . including any Pari Passu Indebtedness.

(Id., § 1.01).

1 U.S. Bank is the Indenture Trustee for the Subordinated Noteholders under the 2006 Indenture.

In 2010, the Debtors issued springing second lien notes (the "Second Lien Notes"). The Second Lien Notes were unsecured when issued, but would become secured if all second lien notes issued in 2009 were redeemed. When the Second Lien Notes were issued, the Debtors stated that "[p]rior to and following the Springing Lien Trigger **[**7]** Date, the [Second Lien] Notes . . . will be senior indebtedness" and rank "senior in right of payment to . . . the Company's existing subordinated notes." (Debtors' Subordinated Notes Ex. 3). In November 2012, the Second Lien Notes became secured by a junior lien--that is, the lien "sprung"--because all of the second lien notes issued in 2009 were redeemed.

In 2012, the Debtors issued two additional classes of senior secured notes--the 1.5 Lien Notes and the First Lien Notes (collectively, the "Senior Lien Notes"). The 1.5 Lien Notes were issued at an interest rate of 10% pursuant to an indenture dated May 25, 2012, and the First Lien Notes were issued at an interest rate of 8.875% pursuant to an indenture dated October 25, 2012.[2] The Senior Lien Notes had a maturity date of October 15, 2020.

2 BOKF is the Indenture Trustee for the First Lien Noteholders, and Wilmington Trust is the Indenture Trustee for the 1.5 Lien Noteholders.

In addition, the Senior Lien Notes provide for the

payment of a "make-whole" premium if the Senior Lien Notes are redeemed before October 15, 2015:

> [P]rior to October 15, 2015, the Issuer may redeem the [Senior Lien] Notes at its option, in whole at any time or in part from **[**8]** time to time . . . at a redemption price equal to 100% of the principal amount of the [Senior Lien] Notes redeemed plus the Applicable Premium as of, and accrued and unpaid interest and Additional Interest, if any, to the applicable redemption date.

(Senior Lien Appellants Ex. C1(A), ¶ 5).[3] The Applicable Premium is the make-whole payment.

> 3 The indentures and notes governing the First Lien Notes and 1.5 Lien Notes are identical in all parts relevant to the disputes at issue in this case. The Senior Lien Notes are attached as Exhibit A to each of the 2012 Indentures.

However, the 2012 Indentures, which govern the Senior Lien Notes, contain an acceleration provision. The acceleration provision is triggered upon an "Event of Default," which includes the voluntary commencement of a bankruptcy proceeding. (Senior Lien Appellants Ex. C1, §§ 6.01(f), 6.02). If such an Event of Default is triggered, "the principal of, premium, **[*326]** if any, and interest on all the [Senior Lien] Notes shall ipso facto become and be immediately due and payable." (Id., § 6.02).

The Senior Lien Notes, along with certain other debt (collectively, the "Senior Secured Loans") are secured by the same collateral (the "Common Collateral") as the Second **[**9]** Lien Notes. An intercreditor agreement (the "Intercreditor Agreement") governs the relationship between the classes of notes. The Intercreditor Agreement provides that the Second Lien Notes are subordinated to the Senior Secured Loans with respect to their position in the Common Collateral. (See U.S. Bank Ex. F § 2). Moreover, the Intercreditor Agreement provides that it does not alter the Second Lien Noteholders' rights as unsecured creditors. (Id. § 5.4).

II. The Plan

The Plan provides no distributions to the holders of the Subordinated Notes.

The Plan also provides that if the holders of the Senior Lien Notes vote in favor of the plan, all outstanding principal and accrued interest on the Senior Lien Notes would be paid in cash to the Senior Lien Noteholders on the effective date of the Plan. (U.S. Bank Ex. A §§ 5.4(a), (b)(i); 5.5(a), (b)(1)).[4] However, no make-whole premium would be allowed. (Id. §§ 5.4(a); 5.5(a)). According to the Plan, if the holders of the Senior Lien Notes vote against the Plan, they would receive "Replacement . . . Notes [the "Replacement Notes"] with a present value equal to the Allowed amount of such holder's Claim," which could--at the Bankruptcy Court's discretion--include a make-whole premium. **[**10]** (Id. §§ 5.4(b)(ii); 5.5(b)(ii)). The Senior Lien Noteholders voted against the Plan. The Bankruptcy Court then determined the Senior Lien Noteholders were not entitled to a make-whole premium.

> 4 To ensure the Debtors would have been prepared to cash-out the holders of the Senior Lien Notes had they voted to approve the Plan, the Debtors obtained financing that would have allowed them to do so.

**DISCUSSION**

I. Legal Standard

The Court has jurisdiction to hear these appeals pursuant to 28 U.S.C. § 158(a). A district court reviews a bankruptcy court's conclusions of law de novo and its findings of fact under a clearly erroneous standard. See In re Ames Dep't Stores, Inc., 582 F.3d 422, 426 (2d Cir. 2009) (citing Momentum Mfg. Corp. v. Emp. Creditors Comm., 25 F.3d 1132, 1136 (2d Cir. 1994)).

II. Subordination Dispute

On behalf of the Subordinated Noteholders, U.S. Bank contends the Plan violates Section 1129(b) of the Bankruptcy Code, which requires that a plan must be "fair and equitable[] with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." 11 U.S.C. § 1129(b)(1). "One of the attributes of a fair and equitable plan is that if an unsecured creditor is not paid in full, 'the holder of any claim or interest that is junior to the claims of [the unsecured creditor] class will not receive or retain under the plan on account of such junior claim or interest any property.'" In re Coltex Loop Cent. Three Partners, L.P., 138 F.3d 39, 42 (2d Cir. 1998) **[**11]** (quoting 11 U.S.C. § 1129(b)(2)(B)(ii)).

The Subordinated Noteholders--unsecured creditors who were not paid in full under the Plan--contend the Plan violates Section 1129(b) by denying them any recovery while providing distributions to the Second Lien Noteholders. Whether the Second Lien Noteholders are entitled to **[*327]** recovery ahead of the Subordinated Noteholders turns on whether the Second Lien Notes are Senior Indebtedness under the 2006 Indenture (which governs the Subordinated Notes).

The 2006 Indenture provides that the Subordinated Notes are "subordinated in right of payment . . . to the prior payment in full of all existing and future Senior Indebtedness of the Company." (U.S. Bank Ex. D, § 10.01). Senior Indebtedness is defined as:

> all Indebtedness . . . unless the instrument creating or evidencing the same or pursuant to which the same is outstanding expressly provides that such obligations are subordinated in right of payment to any other Indebtedness of the Company[;] [the "Base Definition"] . . . provided, however, that Senior Indebtedness shall not include, as applicable:
>
> 4) any Indebtedness or obligation of the Company or any Restricted Subsidiary that by its terms is subordinate or junior in any respect to any other Indebtedness **[**12]** or obligation of the Company . . . including any Pari Passu Indebtedness.

(Id., § 1.01).

U.S. Bank argues that according to the plain language of the Indenture, Senior Indebtedness cannot include debt that is "subordinated in right of payment" (the "in right of payment" clause) or "subordinate or junior in any respect" to any other debt (the "in any respect" clause). Because the Second Lien Notes are secured by a junior lien, U.S. Bank argues they cannot be Senior Indebtedness under the "in any respect" clause. The Debtors argue, and the Bankruptcy Court held, that both clauses exclude payment subordination--rather than lien subordination--from the definition of Senior Indebtedness, and thus the Second Lien Notes are Senior Indebtedness.

The Court agrees with the Debtors and the Bankruptcy Court.

The "interpretation of Indenture provisions is a matter of basic contract law." In re AMR Corp., 730 F.3d 88, 98 (2d Cir. 2013) (internal brackets omitted), cert. denied, 134 S. Ct. 1888, 188 L. Ed. 2d 913 (2014). The parties agree New York law governs this contract dispute. When interpreting a contract, "the intent of the parties governs." Crane Co. v. Coltec Indus., Inc., 171 F.3d 733, 737 (2d Cir. 1999) (quoting Am. Express Bank Ltd. v. Uniroyal, Inc., 164 A.D.2d 275, 277, 562 N.Y.S.2d 613 (1st Dep't 1990)). Intent is ascertained from the "plain meaning" of the language employed. PaineWebber Inc. v. Bybyk, 81 F.3d 1193, 1199 (2d Cir. 1996) (quoting Tigue v. Commercial Life Ins. Co., 219 A.D.2d 820, 821, 631 N.Y.S.2d 974 (4th Dep't 1995)). When analyzing intent, "[t]he rules of contract construction **[**13]** require [the Court] to adopt an interpretation which gives meaning to every provision of the contract." Paneccasio v. Unisource Worldwide, Inc., 532 F.3d 101, 111 (2d Cir. 2008).

"In a dispute over the meaning of a contract, the threshold question is whether the contract is ambiguous." Lockheed Martin Corp. v. Retail Holdings, N.V., 639 F.3d 63, 69 (2d Cir. 2011). "Contract language is not ambiguous if it has a definite and precise meaning . . . concerning which there is no reasonable basis for a difference of opinion." Bayerische Landesbank, N.Y. Branch v. Aladdin Capital Mgmt. LLC, 692 F.3d 42, 53 (2d Cir. 2012) (internal quotation marks omitted). "If the parties' intent is unambiguously conveyed by the plain meaning of the agreement[], then interpretation is a matter of law." Crane Co. v. Coltec Indus., Inc., 171 F.3d at 737 (internal quotation marks omitted).

Before delving into the language of the 2006 Indenture, it is important to understand the difference between lien subordination **[*328]** and payment subordination. Under a lien subordination agreement, "the subordinating party agrees to demote the priority of its lien to that of another secured creditor, thereby delaying its recourse to the identified collateral until the other party's secured claim has been satisfied." Ryan E. Manns & Camisha L. Simmons, Safeguarding Enforcement of Lien Subordination Agreements, 32-5 AM. BANKR. INST. J. 52, 52 (2013). In contrast, payment, or debt, subordination, "entitles the senior creditor **[**14]** to full satisfaction of its superior debt before the subordinated creditor receives payment on its debt." In re First Baldwin Bancshares, Inc., 2013 Bankr.

LEXIS 4086, 2013 WL 5429844, at *7 (S.D. Ala. Sept. 30, 2013). A recent article explains the difference between the two types of subordination:

> Lien subordination involves two senior creditors with security interests in the same collateral, one of which has lien priority over the other. To the extent of any value derived from the collateral (e.g., its liquidation proceeds upon a sale), the senior lien lender is repaid first from collateral proceeds, and the junior lien lender collects only from any remaining collateral value. If the collateral proceeds are insufficient to repay the senior lender in full, then both the senior lien and junior lien lenders, and all other unsecured senior creditors, rank equally in their right to repayment of their remaining debt from the other assets or resources of the borrower. By contrast, in payment subordination, the senior lender enjoys the right to be paid first from all assets of the borrower or any applicable guarantor, whether or not constituting collateral security for the senior or subordinated lenders. Because payment subordination depends only on the amount owed and not on the value of any particular **[**15]** collateral, it is a more fundamental form of subordination and is generally more advantageous to a senior lender.

Robert L. Cunningham & Yair Y. Galil, Lien Subordination and Intercreditor Agreements, THE REV. OF BANKING & FIN. SERVICES, May 2009, at 49, 50.

An examination of the plain language of the definition of Senior Indebtedness reveals that only indebtedness subject to payment subordination, and not indebtedness subject to lien subordination, is excluded. The Base Definition of Senior Indebtedness excludes debt that is "subordinated in right of payment" to any other debt. The words "in right of payment" clearly refer only to payment subordination; thus, the Base Definition excludes only indebtedness subordinated by payment from the definition of Senior Indebtedness.

Six provisos follow the Base Definition. The fourth of those provisos--the "in any respect" clause--provides Senior Indebtedness cannot include debt that is "subordinate or junior in any respect" to other debt. U.S. Bank rests much of its argument on this clause, as upon first glance, it appears to be as broad as possible, thus encompassing both payment and lien subordination. However, closer consideration reveals this **[**16]** is not the case.

First, the six provisos appended to the Base Definition of Senior Indebtedness must be read in conjunction with the Base Definition. See, e.g., Adams v. Suozzi, 433 F.3d 220, 228 (2d Cir. 2005) ("A written contract will be read as a whole, and every part will be interpreted with reference to the whole"). As described above, the Base Definition excludes debt subordinated by payment from the definition of Senior Indebtedness. The provisos can only clarify or augment the Base Definition; they are not a substitute for the Base Definition. See Friedman v. CT Gen. Life Ins. Co., 9 N.Y.3d 105, 114, 877 N.E.2d 281, 846 N.Y.S.2d 64 **[*329]** (2007) ("The purpose of a proviso is to restrain the enacting clause, to except something which would otherwise have been within it, or in some measure to modify it"); White v. United States, 191 U.S. 545, 551, 24 S. Ct. 171, 48 L. Ed. 295, 39 Ct. Cl. 544 (1903) (the usual purpose of a proviso is to "restrain generality, and to prevent misinterpretation"). Thus, when looking to determine the meaning of the "in any respect" clause, the Court is mindful of the words the drafters of the 2006 Indenture chose to use in the Base Definition.

With that in mind, the "in any respect" clause unambiguously clarifies the Base Definition by ensuring the exclusion of indebtedness that is subordinated by payment to other indebtedness "by its terms," even if the instrument creating the indebtedness **[**17]** does not expressly create that subordination. See In re MPM Silicones, LLC, 2014 Bankr. LEXIS 3926, 2014 WL 4436335, at *7 (Bankr. S.D.N.Y. Sept. 9, 2014).[5] The "in right of payment" clause excludes indebtedness expressly subordinated in right of payment, while the "in any respect" clause excludes indebtedness subordinated in right of payment "by its terms."

5 This interpretation is strengthened by the reference to "Indebtedness" at the start of the "in any respect" clause. As the Bankruptcy Court correctly noted, "the parties distinguished liens, which secure indebtedness, from indebtedness itself in several instances in the indenture,

including in the definition of 'Indebtedness' and 'Lien.'" In re MPM Silicones, LLC, 2014 Bankr. LEXIS 3926, 2014 WL 4436335, at *4. By excluding only "Indebtedness" subordinated "by its terms . . . in any respect" from the definition of Senior Indebtedness, the "in any respect" clause makes clear it applies only to payment subordination.

Second, as the Bankruptcy Court correctly noted, if the "in any respect" clause is read--as U.S. Bank contends it must be--to encompass both payment and lien subordination, it would entirely subsume the exclusion of indebtedness "subordinated in right of payment" contained in the Base Definition. Such a construction violates bedrock principles of contract interpretation. See Mastrobuono v. Shearson Lehman Hutton, Inc., 514 U.S. 52, 63, 115 S. Ct. 1212, 131 L. Ed. 2d 76 (1995) ("a document should **[**18]** be read to give effect to all of its provisions and to render them consistent with each other"); Galli v. Metz, 973 F.2d 145, 149 (2d Cir. 1992) ("Under New York law an interpretation of a contract that has the effect of rendering at least one clause superfluous or meaningless . . . is not preferred and will be avoided if possible" (internal quotation marks omitted)). The structure of the definition of Senior Indebtedness renders this interpretation even more implausible; only a tortured interpretation of a contract could read a proviso as entirely subsuming language contained in the Base Definition.

U.S. Bank faults this interpretation of the "in any respect" clause, arguing it fails to give meaning to the words "in any respect." U.S. Bank is wrong. The "in any respect" clause excludes from the definition of Senior Indebtedness "any Indebtedness or obligation of the Company . . . that by its terms is subordinate or junior in any respect to any other Indebtedness." (U.S. Bank Ex. D, § 1.01). "In any respect," placed in context, makes clear that all types of payment subordination--no matter how that payment subordination is created--precludes an obligation from being Senior Indebtedness. It makes perfect sense that the drafters of the Indenture **[**19]** would have included the words "in any respect" when seeking to emphasize that all debt subordinated by right of payment through any non-explicit means is excluded from the definition of Senior Indebtedness.

U.S. Bank next argues this interpretation of Senior Indebtedness--just like the interpretation U.S. Bank proposes--also violates principles of contract construction **[*330]** by rendering the "in right of payment" clause superfluous. U.S. Bank contends debt subordinated in right of payment "by its terms" must include debt "expressly" subordinated in right of payment. However, this type of surplusage--if any exists--is far easier to swallow than that created by the interpretation U.S. Bank proposes. Reading the "in any respect" clause to apply to both lien and payment subordination substitutes the proviso entirely for the Base Definition. Reading the "in any respect" clause to add ways in which payment subordination can be expressed allows the proviso to augment the Base Definition.

Thus, the plain language of the definition of Senior Indebtedness unambiguously provides that Senior Indebtedness excludes only debt subordinated by payment, and not debt secured by a junior lien. The "in any respect" **[**20]** clause augments the Base Definition, clarifying that the instrument creating the debt does not have to render that debt explicitly subordinated by right of payment to other debt; the debt is still excluded from the definition of Senior Indebtedness if it is "by its terms . . . in any respect" subordinated by right of payment.

Other considerations also militate in favor of this interpretation. The 2006 Indenture contains an anti-layering provision, which precludes the Debtors from incurring debt that is "subordinate in right of payment" to any other debt issued by Debtors, unless it is "pari passu" with or "subordinate in right of payment" to the Subordinated Notes. (U.S. Bank Ex. D § 4.13). Nothing contained in the anti-layering covenant prevents the Debtors from issuing debt that is secured by a junior lien but ranks senior in right of payment to the Subordinated Notes. It makes little sense that the anti-layering covenant itself would not prohibit Debtors from issuing such layered debt, but a proviso within the definition of Senior Indebtedness would provide that very same prohibition.[6]

6 U.S. Bank relies upon an article published by Fitch Ratings in February 2006 to support its contention **[**21]** that the "in any respect" clause excludes debt secured by a junior lien from the definition of Senior Indebtedness. The article noted that, at the time, most anti-layering covenants did not preclude issuers from layering senior debt secured by a junior lien. (U.S. Bank Ex. L at 4-5). The article suggested that parties

employ the phrase "subordinated in any respect" in anti-layering covenants should they wish to preclude the layering of such debt. However, that is not what the parties here did. Had the parties intended to follow this advice, logic dictates they would have done so in the anti-layering covenant itself--as the article suggests--rather than in a proviso to the definition of Senior Indebtedness. Moreover, there is no evidence in the record that the parties relied on the Fitch Ratings article, or any other source cited by U.S. Bank, when drafting the 2006 Indenture. And, as Judge Drain correctly pointed out, these sources date from just a few months before the issuance of the Subordinated Notes; thus, "there was no well established standard form that might add a meaningful context to the [2006 I]ndenture's plain terms and internal consistency." In re MPM Silicones, LLC, 2014 Bankr. LEXIS 3926, 2014 WL 4436335, at *8.

Moreover, U.S. Bank concedes **[**22]** that if the lien securing the Second Lien Notes had never sprung, those Notes would constitute Senior Indebtedness. In U.S. Bank's view, the Second Lien Notes were senior to the Subordinated Notes when they were unsecured, but became pari passu with the Subordinated Notes when the junior lien sprang. As the Bankruptcy Court correctly noted, this is an absurd result that should be avoided. See InterDigital Commc'ns Corp. v. Nokia Corp., 407 F. Supp. 2d 522, 530 (S.D.N.Y. 2005) ("'A contract should not be interpreted to produce a result that is absurd, commercially unreasonable or contrary to the reasonable expectations of the parties'" (quoting **[*331]** In re Lipper Holdings, LLC, 1 A.D.3d 170, 171, 766 N.Y.S.2d 561 (1st Dep't 2003)).

Thus, the 2006 Indenture provides that Senior Indebtedness unambiguously excludes only debt subordinated by payment; it does not exclude debt secured by a junior lien.[7]

7 Even though the language of the Indenture is unambiguous, if the Court were to find the definition of "Senior Indebtedness" lacked definite and precise meaning, the extrinsic evidence in the record demonstrates the parties believed the Second Lien Notes were Senior Indebtedness. The Debtors stated in multiple filings with the Securities and Exchange Commission--both at the time of the issuance of the Second Lien Notes and thereafter--that the Second Lien Notes were **[**23]** Senior Indebtedness; no Subordinated Noteholder--nor U.S. Bank--objected to this characterization. This evidence demonstrates the parties considered the Second Lien Notes to be Senior Indebtedness, and further supports the Court's ruling.

U.S. Bank also contends the Second Lien Notes are subordinated by payment to the Senior Secured Loans by the Intercreditor Agreement. The Court does not agree. The Intercreditor Agreement addresses only the relative priorities of the liens securing the Senior Secured Loans and the Second Lien Notes. (See U.S. Bank Ex. F § 2 (entitled "Lien Priorities")). Further, the Intercreditor Agreement provides that it does not alter the Second Lien Noteholders' rights as unsecured creditors. (Id. § 5.4).

Finally, U.S. Bank contends the "primary feature of the [Second Lien Noteholders'] subordination is the requirement that they must wait in line to have their debt paid as to a substantial portion of the Debtor's assets," that is, the Common Collateral. (U.S. Bank Mem. at 11). Thus, even in the provisions of the Intercreditor Agreement that U.S. Bank contends connote payment subordination, "[t]he focus still is on the collateral that was agreed to be secured by the liens." In re MPM Silicones, LLC, 2014 Bankr. LEXIS 3926, 2014 WL 4436335, at * 9. **[**24]** That describes lien--not payment--subordination.

Because the Second Lien Notes are Senior Indebtedness, the Plan--which provides no distributions to the holders of the Subordinated Notes--does not run afoul of Section 1129(b)'s fair and equitable requirement.[8]

8 Nor does the Plan violate the absolute priority rule by preserving certain intercompany interests without paying the Subordinated Noteholders in full. The "technical preservation of equity is a means to preserve the corporate structure that does not have any economic substance and that does not enable any junior creditor or interest holder to retain or recover any value under the Plan. The Plan's retention of intercompany equity interests for holding company purposes constitutes a device utilized to allow the Debtors to maintain their organizational structure and avoid the unnecessary cost of having to

reconstitute that structure." In re Ion Media Networks, Inc., 419 B.R. 585, 601 (Bankr. S.D.N.Y. 2009). That the Second Circuit has rejected the "gifting" doctrine does not undermine this reasoning; the court in In re Ion cited the "gifting" doctrine only "[t]o the extent the preservation of the intercompany equity interests may be deemed an allocation of value" to inappropriate interest holders. Id. at 601 n.22. Moreover, the Court is **[**25]** not convinced--as Judge Drain pointed out--that the Subordinated Noteholders even have standing to raise this issue.

III. The Cramdown Interest Rate Dispute

BOKF, as Trustee for the First Lien Noteholders, and Wilmington Trust, as Trustee for the 1.5 Lien Noteholders (collectively, the "Senior Lien Appellants") also contend the Plan violates Section 1129(b)'s fair and equitable requirement. See 11 U.S.C. § 1129(b). To be "fair and equitable" to fully secured creditors such as the Senior Lien Appellants, a plan must allow the objecting class to "retain the liens" securing its claim and receive "deferred **[*332]** cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property." Id. §1129(b)(2)(A)(i); see also In re Cellular Info. Sys, Inc., 171 B.R. 926, 937 (Bankr. S.D.N.Y. 1994) ("At minimum, a fully secured creditor is treated fairly and equitably if it retains the lien securing its claim and receives deferred cash payments which have a present value equal to the amount of its claim.").

The Senior Lien Appellants contend the Plan violates Section 1129(b) by using the "formula approach" to calculate the cramdown interest rate, and, in the alternative, by calculating the cramdown interest rate **[**26]** under the formula approach incorrectly.

A. Interest Rate Approach

Under the Plan, the Senior Lien Appellants will receive deferred cash payments; thus, they are entitled to interest payments "to ensure that, over time, [they] receive[] disbursements whose total present value equals or exceeds that of the allowed claim." Till v. SCS Credit Corp., 541 U.S. 465, 469, 124 S. Ct. 1951, 158 L. Ed. 2d 787 (2004); see also Rake v. Wade, 508 U.S. 464, 472 n.8, 113 S. Ct. 2187, 124 L. Ed. 2d 424 (1993) ("When a claim is paid off pursuant to a stream of future payments, a creditor receives the 'present value' of its claim only if the total amount of the deferred payments includes the amount of the underlying claim plus an appropriate amount of interest to compensate the creditor for the decreased value of the claim caused by the delayed payments."). The parties dispute the appropriate cramdown interest rate.

The Senior Lien Appellants contend the Court should determine the interest rate using an "efficient market" approach. Under the efficient market approach, the cramdown interest rate is based on the interest rate the market would pay on such a loan, in this case measured by "the rates on the exit and bridge financing the Debtors actually obtained." (Senior Lien Appellants' Mem. at 16). The Debtors contend the Court should use the formula approach laid out **[**27]** by the Supreme Court in Till v. SCS Credit Corp., 541 U.S. 465, 124 S. Ct. 1951, 158 L. Ed. 2d 787 (2004). Under the formula approach, the cramdown interest rate is calculated by augmenting a risk-free (or low risk) base rate "to account for the risk of nonpayment posed by borrowers in the[] financial position" of the debtor. Id. at 471.

The Court agrees with the Debtors and the Bankruptcy Court.

Although the Senior Lien Appellants correctly point out Till was decided in the context of a Chapter 13 bankruptcy--rather than a Chapter 11 bankrupcty--the Court finds much of Till's reasoning applicable in the Chapter 11 context. In Till, the Supreme Court rejected the efficient market approach because it "imposes significant evidentiary costs, and aims to make each individual creditor whole rather than to ensure the debtor's payments have the required present value." Till v. SCS Credit Corp., 541 U.S. at 477. Additionally, the Court noted the efficient market approach "overcompensates creditors because the market lending rate must be high enough to cover factors, like lenders' transaction costs and overall profits, that are no longer relevant in the context of court-administered and court-supervised cramdown loans." Id.

The Second Circuit, in a pre-Till opinion also in the Chapter 13 context, signaled its agreement with **[**28]** this reasoning. In In re Valenti, 105 F.3d 55 (2d Cir. 1997), the Second Circuit rejected the efficient market approach, stating that courts adopting such an "approach misapprehend the 'present value' function of the interest **[*333]** rate." Id. at 63. The court explained that the

cramdown interest rate is meant "to put the creditor in the same economic position that it would have been in had it received the value of its claim immediately. The purpose is not to put the creditor in the same position that it would have been in had it arranged a 'new' loan." Id. at 63-64. The court continued: "[T]he value of a creditor's allowed claim does not include any degree of profit. There is no reason, therefore, that the interest rate should account for profit. . . . Otherwise, the creditor will receive more than the present value of its allowed claim." Id. at 64.

The Court finds the Second Circuit's reasoning in Valenti applicable in the Chapter 11 context. In fact, in Till, the Supreme Court explicitly stated: "We think it likely that Congress intended bankruptcy judges and trustees to follow essentially the same approach when choosing an appropriate interest rate" under any of the various provisions of the Bankruptcy Code requiring a court to "discount a stream of deferred **[**29]** payments back to their present dollar rate." Till v. SCS Credit Corp., 541 U.S. at 474 (internal brackets and quotation marks omitted). The Senior Lien Appellants have provided no good reason why the cramdown interest rate should place Chapter 11 creditors--but not Chapter 13 creditors--in the same position they would have been in had they arranged a new loan. Similarly, the Senior Lien Appellants have provided no good reason why the cramdown interest rate should allow Chapter 11 creditors--but not Chapter 13 creditors--to "receive more than the present value of [their] allowed claim." In re Valenti, 105 F.3d at 64.

The Senior Lien Appellants attempt to distinguish Till and Valenti by pointing to a footnote in Till, which states that "when picking a cramdown rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce." Till v. SCS Credit Corp., 541 U.S. at 476 n.14. The Senior Lien Appellants argue that the Till Court itself acknowledged its reasoning might not apply as forcefully in the Chapter 11 context because unlike in the Chapter 13 context, there may be a "free market of willing cramdown lenders." Id. However, whether the market for a loan is truly efficient or not has no bearing on the Second Circuit's mandate in Valenti that the Bankruptcy Code does not **[**30]** intend to put creditors in the same position they would have been in had they arranged a new loan. Moreover, the language in the Till footnote certainly does not require the application of the efficient market approach in Chapter 11 proceedings. All the footnote can fairly be read to suggest is that a court may want to consider market rates in the Chapter 11 context.

The Senior Lien Appellants also point to precedent from other Circuits, such as the Sixth Circuit in In re American HomePatient, 420 F.3d 559 (6th Cir. 2005), cert. denied, 549 U.S. 942, 127 S. Ct. 55, 166 L. Ed. 2d 251 (2006), in which courts chose to apply the efficient market rate in the Chapter 11 context. See id. at 568 (declining "to blindly adopt Till's endorsement of the formula approach for Chapter 13 cases in the Chapter 11 context" and instead holding if an efficient market exists, then the market rate should apply). However, as Judge Drain correctly pointed out, prior to Till, the Sixth Circuit--unlike the Second Circuit--had applied the efficient market approach in determining the appropriate cramdown rate. Id. at 565-66; see also In re MPM Silicones, LLC, 2014 Bankr. LEXIS 3926, 2014 WL 4436335, at *28. Because Till did not explicitly require the abandonment of the efficient market approach in the Chapter 11 context, the Sixth Circuit decided to continue to use its previous approach. In re **[*334]** Am. HomePatient, 420 F.3d at 567-68 (finding Till did **[**31]** not hold the formula approach is required in the Chapter 11 context). Just as the Sixth Circuit filled the gaps in Till using previous Sixth Circuit precedent, this Court must fill those same gaps by reference to Second Circuit precedent.[9]

9 The Court is aware other bankruptcy and district courts in this Circuit have followed the American HomePatient approach, concluding that when an efficient market exists for comparable financing, that rate should be considered when determining the appropriate cramdown interest rate. However, these cases do not mandate that a bankruptcy court choose the efficient market rate; they simply hold courts should consider whether an efficient market rate exists before determining the cramdown interest rate. See, e.g., In re 20 Bayard Views, LLC, 445 B.R. 83, 107-08 (Bankr. E.D.N.Y. 2011) (explaining "[c]ourts in this Circuit have concluded that the two-step analysis described in American HomePatient is an appropriate way to determine the interest rate that should apply in a Chapter 11 cramdown situation" but finding no efficient market existed (emphasis added)); Mercury Capital Corp. v. Milford CT Assocs., L.P., 354 B.R. 1, 12 (D. Conn. 2006) (holding the bankruptcy court "did not necessarily

err as a matter of law" in applying the formula approach but remanding for consideration of whether an efficient market existed). **[**32]** Judge Drain did, in fact, consider whether an efficient market rate exists in this case, and concluded such a rate does not exist because the financing obtained by the Debtors necessarily included a "built-in profit element" and "recovery for costs and fees." See In re MPM Silicones, LLC, 2014 Bankr. LEXIS 3926, 2014 WL 4436335, at *29.

The Senior Lien Appellants ask the Court to require the Bankruptcy Court to choose a cramdown interest rate that would put them in the same position they would have been in had they arranged a new loan. This is contrary to both Till and Valenti and, thus, the Court declines to do so.

B. Interest Rate Calculation

The Senior Lien Appellants next contend the Bankruptcy Court erred in applying the formula approach because it chose to use the 7-year Treasury rate, rather than the national prime rate used by the Supreme Court in Till, as the base risk-free rate. Judge Drain chose the Treasury rate because it is "often used as a base rate for longer-term corporate debt such as the [R]eplacement [N]otes." In re MPM Silicones, LLC, 2014 Bankr. LEXIS 3926, 2014 WL 4436335, at *31. In contrast, the prime rate may be "a more appropriate base rate for consumers, although [the Second Circuit in] Valenti chose the Treasury rate." Id. The Court agrees with Judge Drain that Till does not obligate a bankruptcy court to choose the national **[**33]** prime rate as the risk-free base rate. See, e.g., In re Vill. at Camp Bowie I, L.P., 454 B.R. 702, 713 (Bankr. N.D. Tex. 2011) (noting "Till's direction to use a formula approach to fixing an interest rate does not require, from case to case, use of the prime rate"); see also Mercury Capital Corp. v. Milford CT Assocs. L.P., 354 B.R. at 13 (remanding for bankruptcy court to consider whether it is "appropriate to use the national prime rate or some other rate"). Thus, Judge Drain's choice of the 7-year Treasury rate is appropriate.[10]

10 In fact, Judge Drain added an additional amount "to the risk premium in light of the fact that the [D]ebtors used Treasury rates [rather than the prime rate] as the base rate." In re MPM Silicones, LLC, 2014 Bankr. LEXIS 3926, 2014 WL 4436335, at *32. He stated the adjustment "adequately [took] into account risks inherent in the [D]ebtors' performance of the [R]eplacement [N]otes above the essentially risk-free Treasury note base rates." Id.

Similarly, the risk premiums chosen by Judge Drain for both the First Lien Notes and the 1.5 Lien Notes are well within the bounds of reasonableness. The Senior Lien Appellants correctly point out that neither Till nor Valenti requires a risk premium of 1 to 3%. However, Judge **[*335]** Drain did not construe those cases to require that the risk premium fall in a specific range; instead, he stated he thought a risk premium of 1 to 3% is appropriate "unless there are extreme risks **[**34]** that . . . do not exist here." In re MPM Silicones, LLC, 2014 Bankr. LEXIS 3926, 2014 WL 4436335, at *31. Thus, Judge Drain considered whether to apply a risk premium higher than 3%, but decided not to do so. This Court will not disturb his well-reasoned determination of the proper rate to apply.

IV. The Make-Whole Dispute

The Senior Lien Appellants additionally contend the Bankruptcy Court erred in failing to award them a "make-whole" premium. Whether the Senior Lien Appellants are owed a make-whole premium turns on language in both the 2012 Indentures and the Senior Lien Notes themselves. The Senior Lien Notes provide for the payment of a make-whole premium if the Senior Lien Notes are redeemed before October 15, 2015. However, the 2012 Indentures, which govern the Senior Lien Notes, contain an acceleration clause triggered by the voluntary commencement of a bankruptcy proceeding. (Senior Lien Appellants Ex. C1, §§ 6.01(f), 6.02). The acceleration clause provides that in the event of a bankruptcy proceeding, "the principal of, premium, if any, and interest on all the [Senior Lien] Notes shall ipso facto become and be immediately due and payable." (Id., § 6.02).

The Senior Lien Appellants contend the Debtors' commencement of the Chapter 11 proceeding constituted a redemption **[**35]** of the Senior Lien Notes prior to October 15, 2015, such that the Senior Lien Noteholders are entitled to a make-whole payment. The Debtors contend that the acceleration provision was triggered when they filed for bankruptcy, negating the Senior Lien Appellants' right to a make-whole premium.

The Court agrees with the Debtors and the

Bankruptcy Court that the Senior Lien Appellants are not entitled to a make-whole premium.

As described above, the "[i]nterpretation of Indenture provisions is a matter of basic contract law." In re AMR Corp., 730 F.3d at 98 (internal quotation marks omitted), cert. denied, 134 S. Ct. 1888, 188 L. Ed. 2d 913 (2014). The parties agree New York law governs the interpretation of the 2012 Indentures and the Senior Lien Notes.

Section 6.01(f) of the 2012 Indentures provides that the commencement of a Chapter 11 proceeding is an Event of Default. See 2012 Indentures § 6.01(f) ("An 'Event of Default occurs if . . . the Company or any Significant Subsidiary pursuant to or within the meaning of any Bankruptcy Law commences a voluntary case."). Further, a Section 601(f) Event of Default triggers the acceleration clause contained in Section 6.02 of the 2012 Indentures. That acceleration clause provides:

> If an Event of Default (other than an Event of Default specified in Section 601(f) . . . ) occurs and is continuing, **[**36]** the Trustee or the Holders of at least 25% in principal amount of outstanding [Senior Lien] Notes, by notice to the Company may declare the principal of, premium, if any, and accrued but unpaid interest on all the [Senior Lien] Notes to be due and payable. . . . If an Event of Default specified in Section 6.01(f) . . . occurs, the principal of, premium, if any, and interest on all the [Senior Lien] Notes shall ipso facto become and be immediately due and payable without any declaration or other act on the part of the Trustee or any Holders. The Holders of a majority in principal amount of outstanding [Senior Lien] Notes by notice to the Trustee may rescind any such acceleration with respect to the Notes and its consequences.

**[*336]** (2012 Indentures § 6.02). Thus, acceleration can be invoked at the noteholders' option for non-bankruptcy events, but acceleration is mandatory in the case of the voluntary filing of a bankruptcy petition. See In re AMR Corp., 730 F.3d at 98-99 (finding a similar acceleration clause provided noteholders with an option to invoke acceleration as a remedy for a non-bankruptcy default but was mandatory with regard to the voluntary filing of a bankruptcy petition).

Having determined the filing of the bankruptcy case triggered **[**37]** an automatic acceleration of the Senior Lien debt, the Court must determine whether a make-whole payment is due to the Senior Lien Noteholders under such circumstances. Under New York law, "[g]enerally, a lender forfeits the right to a prepayment consideration by accelerating the balance of the loan. The rationale most commonly cited for this rule is that acceleration of the debt advances the maturity date of the loan, and any subsequent payment by definition cannot be a prepayment." U.S. Bank Nat'l Ass'n v. S. Side House, LLC, 2012 U.S. Dist. LEXIS 10824, 2012 WL 273119, at *4 (E.D.N.Y. Jan. 30, 2012) (internal citations omitted). However, courts recognize an exception to this rule "when a clear and unambiguous clause . . . calls for payment of the prepayment premium." 2012 U.S. Dist. LEXIS 10824, [WL] at *5 (internal quotation marks omitted).

Two separate clauses of the agreements potentially provide for a make-whole provision in the context of an acceleration of debt: first, the acceleration clause, and second, the make-whole provision itself.

The acceleration clause does not clearly and unambiguously call for the payment of the make-whole premium in the event of an acceleration of debt. To the contrary, the acceleration clause provides the "premium, if any" shall become immediately payable upon the triggering of the acceleration clause. (2012 **[**38]** Indentures § 6.02). This language is not sufficient to create an unambiguous right to a make-whole payment. Courts allowing make-whole payments under these circumstances have largely required the contract to provide explicitly for a make-whole premium in the event of an acceleration of debt or a default. See, e.g., U.S. Bank Nat'l Ass'n v. S. Side House, LLC, 2012 U.S. Dist. LEXIS 10824, 2012 WL 273119, at *7 (citing with approval a case in which "the court permitted prepayment premiums where the Note provided that '[u]pon the Lender's exercise of any right of acceleration . . . Borrower shall pay to Lender, in addition to the entire unpaid principal balance outstanding . . . (B) the prepayment premium.").

Neither does the make-whole provision contained in paragraph 5 of the Senior Lien Notes clearly and

unambiguously call for the payment of the make-whole premium upon acceleration of debt. The Senior Lien Appellants contend that, under the make-whole provision, regardless of whether the voluntary commencement of the bankruptcy case was an Event of Default triggering a mandatory acceleration of the debt, the early payment of the debt constituted a redemption prior to October 15, 2015.

However, under New York law, the payment of debt pursuant to an acceleration clause does not constitute an **[**39]** early redemption. Instead, the automatic acceleration of the debt under Section 6.02 of the 2012 Indentures "changed the date of maturity from some point in the future . . . to an earlier date based on the debtor's default under the contract." In re AMR Corp., 730 F.3d at 103 (internal quotation marks and brackets omitted). Thus, "[w]hen the event of default occurred and the debt accelerated, the new maturity date for the debt was [the date of the filing of the bankruptcy case]." Id. Consequently, the repayment of the debt in connection **[*337]** with the bankruptcy proceeding is not a redemption because "'[p]repayment can only occur prior to the maturity date.'" Id. (citing In re Solutia Inc., 379 B.R. 473, 488 (Bankr. S.D.N.Y. 2007)).[11]

11 The Senior Lien Appellants contend "prepayment" is different than "redemption" because a redemption is not limited to payments before maturity but "refers simply to the payment of notes, without regard to maturity." (Senior Lien Appellants Mem. at 33). However, the provisions at issue in In re AMR Corp. also provided for a make-whole premium if the debt was "redeem[ed]" early, see In re AMR Corp., 730 F.3d at 94 n.8, 103, but when the debt was automatically accelerated due to default, the court there held that the "post-maturity payment [was] not a voluntary redemption." Id. at 103; see also id. at 97 (noting the law in this Circuit "supports **[**40]** the conclusion that a payment of debt due upon acceleration is different from voluntary redemption"). Thus, the Second Circuit has rejected the very distinction the Senior Lien Appellants attempt to draw.

To be sure, the provisions at issue in In re AMR Corp. are different from those at issue here in one important respect: there, the make-whole provision signals that the acceleration clause controls when it applies. In re AMR Corp., 730 F.3d at 103 (noting the voluntary redemption payment provision "states that it operates '[e]xcept as otherwise provided in [the acceleration clause]'" (emphasis in In re AMR)). By contrast, here, the make-whole provision does not refer to the acceleration clause at all. This difference does not change the Court's conclusion that the repayment of the debt pursuant to the acceleration clause is not a redemption because "'[p]repayment can only occur prior to the maturity date." In re AMR Corp., 730 F.3d at 103 (citing In re Solutia Inc., 379 B.R. at 488).

Next, the Senior Lien Appellants argue the make-whole provision satisfies the explicitness requirement because it contains a date certain--October 15, 2015--before which redemption triggers the make-whole payment. They contrast this with a hypothetical provision that would condition the triggering of a make-whole payment **[**41]** upon redemption before maturity, and cite In re Chemtura Corp., 439 B.R. 561 (Bankr. S.D.N.Y. 2010), in support of this distinction. However, the provision at issue in Chemtura required a make-whole payment if the debt was repaid prior to its original maturity date. In re Chemtura Corp., 439 B.R. at 601. That is specific enough to meet the clear and unambiguous requirement. See Scott K. Charles & Emil A. Kleinhaus, Prepayment Clauses in Bankruptcy, 15 AM. BANKR. INST. L. REV. 537, 556 (2007) (noting that for lenders who would like to ensure their right to a make-whole payment in the event of acceleration of debt due to bankruptcy, "the optimal strategy is to negotiate a provision that requires the borrower to pay a prepayment fee whenever debt is repaid prior to its original maturity"). By contrast, the make-whole provision at issue here does not require a make-whole payment if the debt is repaid prior to its original maturity.

The Senior Lien Appellants contend such a result "makes no commercial sense, contrary to the tenet of New York contract law that courts should avoid interpretations that would be absurd, commercially unreasonable, or contrary to the reasonable expectations of the parties." (Senior Lien Appellants Mem. at 26 (internal quotation marks omitted)). However, this result is exactly what the Senior Lien Appellants bargained **[**42]** for under the 2012 Indentures. The Senior Lien Appellants agreed to accelerate the debt owed to them in the event of a default, establishing they "'preferred,

sensibly no doubt, accelerated payment over the 'opportunity' to earn interest from the . . . loan over a period of years.'" U.S. Bank Nat'l Ass'n v. S. Side House, LLC, 2012 U.S. Dist. LEXIS 10824, 2012 WL 273119, at *4 (quoting In re LHD Realty Corp., **[*338]** 726 F.2d 327, 331 (7th Cir. 1984)). Here, the Senior Lien Appellants bargained for the acceleration of debt in the event of a default, and must live with the consequences of their bargain.[12]

12 It matters not that the Senior Lien Noteholders' right to rescind the acceleration of the debt was canceled by the application of the automatic stay pursuant to Section 362 of the Bankruptcy Code. The Debtors correctly point out that all contracts signed among the parties operate against the backdrop of the relevant Bankruptcy Code provisions. The potential for an automatic stay upon the filing of a bankruptcy case is a part of the bargain to which the parties agreed.

Neither the 2012 Indentures nor the Senior Lien Notes themselves clearly and unambiguously provide that the Senior Lien Noteholders are entitled to a make-whole payment in the event of an acceleration of debt caused by the voluntary commencement of a bankruptcy case. Thus, the Bankruptcy Court correctly held that **[**43]** the Senior Lien Noteholders are not entitled to a make-whole payment.[13]

13 Neither are the Senior Lien Noteholders entitled to damages in the amount of the make-whole premium under the perfect tender rule. First, the existence of the make-whole provision modified the perfect tender rule such that the common law remedy is unavailable. See, e.g., U.S. Bank Nat. Ass'n v. S. Side House, LLC, 2012 U.S. Dist. LEXIS 10824, 2012 WL 273119, at *4; Charles & Kleinhaus, Prepayment Clauses in Bankruptcy, 15 AM. BANKR. INST. L. REV. at 543 ("While a no-call memorializes the common law default rule that prepayment is not permitted absent lender consent, a prepayment fee effectively opts out of that default rule."). Second, the Senior Lien Appellants claim these damages "for breach of contract," which occurred "when the Debtors redeemed the Notes and prevented the [Senior Lien] Noteholders from exercising their right to rescind acceleration." (Senior Lien Appellants Mem. at 39). However, the automatic stay--and not the Debtors--prevented the Senior Lien Appellants from exercising their right to rescind. The Court is not convinced such a circumstance can lead to liability for breach of contract on the part of the Debtors. See, e.g., HSBC Bank USA Nat'l Ass'n v. Calpine Corp., 2010 U.S. Dist. LEXIS 96792, 2010 WL 3835200, at *4 (S.D.N.Y. Sept. 15, 2010) ("Because Debtor's bankruptcy filing rendered the no-call provision in the notes unenforceable and liability cannot be incurred pursuant to an unenforceable **[**44]** contractual provision, Debtor did not incur any liability for repaying the notes." (collecting cases)).

**CONCLUSION**

The Bankruptcy Court's Orders of September 9 and September 11, 2014, are AFFIRMED.

The Clerk is instructed to terminate as moot the Debtors' motions to dismiss the appeals. (Doc. #11 in 14-cv-7471, Doc. #11 in 14-cv-7472, and Doc. #18 in 14-cv-7492).[14]

14 The Debtors have moved to dismiss these appeals as equitably moot. However, the motions to dismiss the appeals as equitably moot are themselves mooted by this Court's decision to affirm the Orders of the Bankruptcy Court. See In re Metromedia Fiber Network, Inc., 416 F.3d 136, 144 (2d Cir. 2005) ("Because equitable mootness bears only upon the proper remedy, and does not raise a threshold question of our power to rule, a court is not inhibited from considering the merits before considering equitable mootness.").

The Clerk is further instructed to terminate the pending appeals and close these cases.

Dated: May 4, 2015

White Plains, NY

SO ORDERED:

/s/ Vincent L. Briccetti

Vincent L. Briccetti

United States District Judge

# TAB 4

LATHAM & WATKINS

Client Alert
Commentary

Latham & Watkins Restructuring, Insolvency & Workouts Practice October 16, 2014 | Number 1756

# *The Weakest Link in Intercreditor Agreements Breaks Again in* Momentive

***The U.S. Bankruptcy Court's recent decision highlights the pitfalls of ambiguous intercreditor agreements for senior creditors.***

## Why the *Momentive* case is important

Intercreditor agreements among secured creditors with respect to common collateral are often limited to lien subordination, so as to govern each secured creditors' rights over the common collateral, without imposing claim subordination that would require junior creditors to subordinate their claims and turn over all of their recoveries, whether or not derived from proceeds of collateral. Intercreditor agreements that provide only for lien subordination typically include a reservation of rights for junior creditors to retain all of their rights as unsecured creditors; however, the formulation of this reservation varies from agreement to agreement, and as discussed below, the exact language used can be critical in a court's analysis.

The recent decision in *In re MPM Silicones, LLC*, Case No. 14-22503 (RDD) (Bankr. S.D.N.Y. Sept. 30, 2014) (*Momentive*) reflects the emerging trend of courts narrowly interpreting restrictions on junior creditors in these intercreditor agreements, where the restrictions are ancillary to the distribution of the common collateral's value. In *Momentive*, the bankruptcy found that the general reservation of rights as unsecured creditors serves to "ameliorate obligations that [junior secured creditors have] undertaken elsewhere in the agreement."

## Senior creditors bear the risk of ambiguity in intercreditor agreements

A high stakes example of what can happen with generalized drafting in intercreditor agreements bore out in the chapter 11 cases titled *In re Boston Generating, LLC* (*Boston Gen*).[1] In that case, the bankruptcy court read prohibitions on junior creditor actions narrowly, so as to allow the junior creditors to object to bidding procedures for a sale of substantially all assets, despite a loosely-drafted prohibition on objecting to assets sales to which senior creditors had consented.

The court explained that the purpose of the intercreditor agreement was to put the senior creditors "'in the driver's seat' when it came to decisions regarding collateral." Nevertheless, the court held that waivers of rights to object to the procedures used for a sale of assets "must be clear beyond peradventure." The court acknowledged that the case was a "close call" and that the outcome was the result of a "perfect storm of a poorly drafted agreement" and other facts and equitable circumstances particular to that case.

In contrast, courts tend to uphold express prohibitions on specific types of actions. For example, courts often enforce agreements by a junior creditor not to contest liens of a senior creditor.[2] Similarly, courts have upheld an agreement by a junior creditor to authorize the senior creditor to vote both creditors'

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claims,[3] although some courts find such assignments of voting rights to be unenforceable as a matter of policy.[4]

Courts are more likely to enforce prohibitions on actions by junior creditors when the provisions that reserve a junior creditor's rights as unsecured creditors are drafted carefully so as not to modify other obligations under the agreement. Such clauses should be formulated with an introductory clause along the lines of "Except as otherwise specifically set forth in this Agreement, . . .", as opposed to "Notwithstanding anything to the contrary in this Agreement, . . . ."[5]

## The *Momentive* decision is another example of the emerging trend

As background, in the *Momentive* case, the chapter 11 plan provides, generally speaking, for junior creditors to receive new equity in the debtors in exchange for their claims, and for senior creditors to receive new debt secured by the same collateral that secured their prepetition loans. The senior creditors rejected the plan, and the debtors sought confirmation on a cram down basis. In addition, the debtors objected to the senior creditors' make-whole claims. Certain of the junior creditors entered into a restructuring support agreement with the debtors and extended a backstop commitment for the equity rights offering in connection with the plan.

The senior creditors contested the plan through objections to confirmation and litigation over their make-whole claim. The senior creditors also filed a complaint in state court against the junior creditors for breach of the intercreditor agreement. The junior creditors removed the action to the district court, which automatically referred the matter to the bankruptcy court.

The bankruptcy court confirmed the debtors' chapter 11 plan on a cram down basis and, at the same time, disallowed the senior creditors' make-whole claim and denied the senior creditors' motion to remand their litigation over the intercreditor agreement back to state court. The bankruptcy court then held a subsequent hearing on motions to dismiss the senior creditors' complaint for breach of the intercreditor agreement.

The legal question in the *Momentive* case was whether to dismiss causes of action — asserted by senior creditors — for breach of contract against junior creditors arising from several types of alleged actions by junior creditors, which were, generally speaking:

- Opposition to requests for adequate protection and payment of financial advisors of senior creditors, and support for priming debtor-in-possession (DIP) financing without consent of senior creditors
- Opposition to a make-whole claim of senior creditors, support for a plan that crams down senior creditors, and entry into a restructuring support agreement in favor of the cram down plan
- Receipt of alleged proceeds of collateral that were not held in trust for senior creditors, comprised of a US$30 million backstop fee, reimbursement of professional fees and expenses, and new equity in the debtors to be distributed under the plan

The bankruptcy court dismissed all of the senior creditors' causes of action. The court dismissed the first type of claims without prejudice, so as to permit the senior creditors to replead the claims to cure their pleading deficiencies — to the extent the facts of the case allowed. The court noted that, based on its review of the intercreditor agreement, there was no provision prohibiting support for a priming loan; rather, the only prohibition was a prohibition on objecting to a priming loan supported by the senior creditors. On these causes of action, the court essentially found that the senior creditors had not adequately alleged exactly what actions the junior creditors took to breach the intercreditor agreement.

The bankruptcy court dismissed the second and third types of causes of action with prejudice, so as to bar the senior creditors from pursuing those claims as a matter of law, unless the bankruptcy court is reversed on appeal. In particular, the senior creditors conceded that they would have no cause of action against the junior creditors for opposition to the senior creditors' make-whole claim, unless the bankruptcy court's decision disallowing that claim is reversed.

**Senior creditors should draw several key lessons from the decision:**

**Restrictions on action should be specific:** The *Momentive* court followed the reasoning of *Boston Gen* and held that rights to object to a secured creditor's claim and rights with respect to treatment of a claim though a plan (*i.e.*, cram down of senior creditors) should not be curtailed "unless very clearly precluded or constrained by an intercreditor agreement of this nature." The court, based on its own review of the agreement, found that the language generally prohibiting actions to "hinder any exercise of remedies" by the senior creditors did not provide a clear basis to deprive a junior creditor of its rights as an unsecured creditor to contest claims.

Furthermore, because the debtors and not the junior creditors themselves objected to make-whole claims and proposed the cram down plan, the court found that the junior creditors' actions were limited to encouraging the debtors to take these actions. In this manner, the debtors' role in leading the prosecution of matters adverse to the senior creditors insulated the junior creditors from liability under the loose terms of the intercreditor agreement at issue.

As the *Momentive* decision exhibits, if the senior creditors have the market leverage to do so, intercreditor agreements should clearly restrict the actions of junior creditors by explicit language rather than relying exclusively on general language to provide confidence that junior creditors will be constrained from supporting action adverse to senior creditors.

**New equity and certain other distributions are not the proceeds of collateral:** The bankruptcy court rejected causes of action that the junior lenders improperly received and retained the proceeds of collateral in the form of a US$30 million backstop fee, reimbursement of professional fees and expenses, and new equity in the debtors to be distributed under the plan.

The bankruptcy court determined, as a matter of New York law, that new equity in the reorganized debtors that continue to own the same collateral is not a receipt of proceeds of collateral. The court held that proceeds of collateral are essentially "whatever is the result of the transformation of the collateral." Under the facts of this case, the court found that there was no change to the senior creditors' collateral and therefore no proceeds as a result of the plan.

In contexts where the parties have agreed to lien subordination but not claim subordination, this holding underscores the need to define specifically the relative rights of senior and junior creditors.

## Conclusion

At present, an order has not yet been entered in the *Momentive* chapter 11 cases that will formally dismiss the senior lenders' claims. Upon entry of that order, the senior lenders will be entitled to appeal the bankruptcy court's decision and/or file a motion to amend their complaint with respect to claims that were dismissed without prejudice.

All participants in complex commercial financing transactions should continue to follow the *Momentive* proceedings closely. Senior creditors would be well advised to consider the lessons of this case as they draft new intercreditor agreements. In particular, senior creditors seeking to avoid the result in *Momentive* should consider how to make their intercreditor agreements more precise, whether to take a pledge of shares in the holding company, and, in the event of disputes, whether to advance other legal arguments on the question of whether new equity constitutes proceeds of common collateral.

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If you have questions about this *Client Alert*, please contact one of the authors[6] listed below or the Latham lawyer with whom you normally consult:


**Lawrence Safran**
larry.safran@lw.com
+1.212.906.1711
New York

**Mitchell A. Seider**
mitchell.seider@lw.com
+1.212.906.1200
New York

**Keith A. Simon**
keith.simon@lw.com
+1.212.906.1372
New York

**Adam J. Goldberg**
adam.goldberg@lw.com
+1.212.906.1828
New York


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**Endnotes**

[1] 440 B.R. 302 (Bankr. S.D.N.Y. 2010).

[2] *See, e.g., In re Ion Media Networks, Inc.*, 419 B.R. 585 (Bankr. S.D.N.Y. 2009).

[3] *See, e.g., In re Aerosol Packaging, LLC*, 362 B.R. 43 (Bankr. N.D. Ga. 2006).

[4] *See, e.g., In re SW Boston Hotel Venture, LLC*, 460 B.R. 38 (Bankr. D. Mass. 2011) (holding an assignment of plan voting rights to be unenforceable).

[5] *Compare In re Ion Media Networks, Inc.*, 419 B.R. at 597-98 (denying junior creditors standing to object to chapter 11 plan), with *Momentive*, Hearing Tr. Sept 30, 2014 102:12-22 (dismissing claims by senior creditors for breach of intercreditor agreement).

[6] The authors of this Client Alert were not involved in representation of any party in connection with the *Momentive* bankruptcy cases.

# TAB 5

# Insolvency and Restructuring Update

## *Momentive* Ruling Highlights Risks to Senior Creditors Under Intercreditor Agreements

October 7, 2014

As we discussed in our recent client memorandum *(available **here**)*, the oversecured senior lien creditors of chapter 11 debtor Momentive Performance Holdings and its affiliates failed in the context of the plan confirmation hearing to persuade the bankruptcy court that the debtors' chapter 11 plan did not satisfy the cramdown standard, even though the replacement notes proposed to be distributed to them had below-market interest rates. The senior lien creditors also lost a dispute with Momentive—and with second lien noteholders that intervened in the dispute—regarding their entitlement to a make-whole payment.

Following these confirmation rulings, on September 30, 2014, the bankruptcy court rejected the senior lien creditors' efforts to make up their losses by obtaining a recovery from Momentive's second lien noteholders under an intercreditor agreement that prohibits the second lien noteholders from receiving any recovery from the "common collateral" until the senior lien creditors are "paid in full in cash" and from taking certain actions in opposition to the senior lien creditors. The court dismissed the senior lien creditors' core claims, holding that (1) the equity distributed to second lien noteholders did not constitute *"proceeds" of common collateral* and (2) intervening in the make-whole dispute and supporting the debtors' cramdown plan did not violate the intercreditor agreement because the second lien noteholders were acting as unsecured creditors and disputing the *amount* of the senior lien creditor' claims and the adequacy of their proposed distribution, not their entitlement to *collateral.*

The court's holdings highlight the limited protection offered by lien subordination, as compared to payment subordination, unless the relevant agreement is carefully drafted to protect the senior creditor, which the market often does not permit. Furthermore, the decision shows that the carefully crafted prohibitions on second lien creditors can be swallowed by overbroad language preserving those creditors' rights to participate in the bankruptcy proceedings as "unsecured creditors".

### The Senior Lien Creditors' Arguments

In July 2014, Momentive's senior lien creditors filed state court actions against certain second lien noteholders that, under the debtor's plan of reorganization, were slated to receive the equity of the reorganized debtor. These actions were ultimately removed to federal court over the senior lien creditors' opposition, where they were referred to the bankruptcy court to be heard by the bankruptcy court.

In their complaints, the senior lien creditors pressed two primary theories. The first was that the second lien noteholders could not receive the payments and distributions they were slated to receive, including the equity of the reorganized company, reimbursement of professional fees and (potentially) a $30 million fee for backstopping a rights offering, so long as the senior lien creditors were not paid in full in cash. Since the senior lien creditors were to receive replacement notes that could not be sold for the full value of their claims, the senior lien creditors argued that the second lien noteholders are required to turn over a portion of their recovery to make the senior lien creditors whole. The second theory was that the second lien noteholders had, by signing a restructuring support agreement in respect of the debtors' plan and intervening in the make-whole dispute, violated the intercreditor agreement's strictures prohibiting the second lien noteholders from enforcing rights or exercising remedies, or objecting to relief sought by the senior lien creditors. As a remedy, the senior lien noteholders sought turnover of equity and backstop fees distributed to the second liens until they are paid in full in cash, in addition to unspecified damages to compensate them for violations of the intercreditor agreement.

## The Second Lien Noteholders' Motion to Dismiss

The second lien noteholders' primary response to both of the senior lien creditors' theories was that the intercreditor agreement concerns only rights with respect to collateral or proceeds of collateral. In other words, they emphasized that the intercreditor agreement provides for lien subordination and not payment subordination, arguing that none of the challenged actions relate to the common collateral. With respect to receipt of stock in the reorganized debtors, professional fee reimbursement and a potential backstop fee, the second lien noteholders argued that none constituted proceeds of the collateral, noting that the company in fact retained all collateral under the plan and would repledge it to the senior lien creditors in connection with their replacement notes. And with respect to intervention in the make-whole dispute, they argued that the dispute "has nothing to do with remedies in respect of Common Collateral" and that "[s]imply put, there is no prohibition against questioning the amount of the [senior lien creditors'] claims."

With respect to the claim that they were to receive proceeds of collateral before the first lien obligations were discharged, they argued that "[o]nce the Senior Lien Lenders receive the Replacement Notes, they will have been paid in full as a matter of law," and therefore will not be entitled to any additional payment irrespective of what the intercreditor agreement provides. Additionally, they highlighted that the intercreditor agreement only prohibits a second lien noteholder from receiving proceeds "in the context of its role as secured creditor," arguing that none of the payments or distributions were owed to them in that capacity. With respect to the backstop fee and professional fees, they pointed out that these were being paid to them in their capacity as backstop parties, not as secured creditors. And with respect to the equity distribution, they insisted that they could have "achieved exactly the same result that they achieved here" had they merely been unsecured creditors. Finally, the second lien noteholders argued that their intervention in the make-whole dispute and participation in the bankruptcy case might have been as unsecured creditors, and therefore was permitted under section 5.4 of the intercreditor agreement, which provides that "[n]otwithstanding anything to the contrary in this Agreement," the second lien noteholders "may exercise rights and remedies as an unsecured creditor."

## The Court's Decision

After lengthy oral argument, the court announced its decision from the bench, observing at the outset that "[t]he ICA is very clearly an intercreditor agreement pertaining to the parties' collateral rights. That is the overall context of the agreement, and it is in that context that the claims should be evaluated." The court also embraced the position, previously espoused by the court in the *Boston Generating* case, that waivers of a secured creditor's rights under an intercreditor agreement "must be clear beyond peradventure." These two ideas—the collateral-specific nature of the intercreditor arrangements and the principle that waivers of creditors' rights should be construed narrowly—animated the court's views with respect to the bulk of the issues in front of it.

First, the court held that in supporting the debtors' plan and intervening in the make-whole dispute, the second lien noteholders were not interfering with the senior lien creditors' rights in the collateral. In the make-whole dispute, they were disputing the amount of the claims, and by supporting the plan they were merely supporting permissible treatment of the senior lien claims under the cramdown provision of the Bankruptcy Code. Importantly, the court pointed out that the intercreditor agreement at issue did not contain more sweeping provisions, known as "silent second lien" provisions, that would have precluded the second lien noteholders from taking a broad array of actions in the bankruptcy case that do not concern the collateral, such as supporting or objecting to a plan of reorganization. According to the court, by preserving the second lien noteholders' rights as unsecured creditors, the intercreditor agreement precluded a broad construction that would mandate silence on non-collateral related issues.

Second, the court dismissed the senior lien creditors' assertion that the equity distribution, professional fee reimbursement and potential backstop fees were proceeds of collateral and thus subject to turnover. The court rejected with particular force the idea that the equity distribution constituted proceeds of the

senior lien creditors' collateral, reasoning that the equity was received in exchange for the second lien noteholders' liens, not for the assets encumbered by those liens. Moreover, the court found that the distribution of equity, rather than diminishing the senior lien creditors' collateral, reduced the amount of debt by which it was encumbered. With respect to the backstop fee, the court reasoned that although the cash may be collateral, the second lien noteholders were not receiving it "in connection with the exercise of any right or remedy relating to Common Collateral," as required to violate the intercreditor agreement. With respect to the professional fees, the court dismissed the claim without prejudice, on the grounds that the complaint was insufficiently specific because it did not make clear on what basis (and therefore in what capacity) the second lien noteholders were receiving these fees. Importantly, although the parties' briefs devoted significant attention to the question of whether the senior lien noteholders had in fact been "paid in full," the court's findings on these points rendered that issue irrelevant, as the court found that the distributions to the second lien noteholders at issue were permitted regardless of whether the senior lien debt had been paid or not.

The majority of the alleged violations of the intercreditor agreement were thus dismissed with prejudice on the basis that the agreement narrowly concerns collateral, and that the second lien noteholders, in their capacity as such, did not receive proceeds of collateral or take any other actions in respect of collateral. With respect to the second lien noteholders' alleged opposition to adequate protection, the court dismissed the claim without prejudice, holding that the claim was not pled with sufficient specificity. However, the court also indicated ambivalence about whether, if pled sufficiently, this opposition was a permissible exercise of the rights of unsecured creditors, giving credence to the second lien noteholders' broad reading of this provision, while acknowledging that their construction could undermine many of the more specific provisions of the agreement.

## Implications and Takeaways

This most recent *Momentive* decision highlights important issues for secured creditors with respect to the establishment of priority and other intercreditor rights by agreement. First and foremost, the decision offers a striking example of the limitations of lien subordination and the limited protections it offers to senior lien creditors if intercreditor agreements are not drafted to clearly protect the senior creditors, a circumstance that is frequently dictated by market pressures. Here, lien subordination did not assure a full value recovery by the senior lien creditors, despite the fact that they were oversecured. Lien subordination also did not prevent junior creditors from receiving substantial distributions in respect of their secured claims, including equity, fees and potentially a significant backstop fee, in spite of the fact that the senior lien creditors were not being paid in full in cash or in value. Lien subordination also failed to prevent the junior creditors from mounting a broad attack on the rights of the senior creditors in the bankruptcy case. More broadly, the case is a reminder of the inherent uncertainty and litigation risk that lien subordination carries as to the division of distributable value between collateral and non-collateral value, especially where the lien subordination does not expressly include subordination in respect of distributions on secured claims in bankruptcy, regardless of source or form, even if not from collateral or proceeds of collateral.

The decision also demonstrates that carveouts preserving the rights of subordinated creditors to act as unsecured creditors can be construed broadly to undo more specific senior creditor protections in the rest of the agreement, particularly if not drafted to clearly preserve those protections for senior creditors. Although the court did not rest its decision entirely on this provision, at oral argument Judge Drain noted that preserving the right to act as unsecured creditors might "trump" the more specific prohibitions in the agreement.

Finally, in the wake of the court's cramdown ruling, it is noteworthy that the question of whether the senior lien creditors had in fact been paid in full was not ultimately relevant to the court's decision, given the court's view of the limitations of lien subordination. Although the second lien noteholders argued that the

senior claims were "discharged" as a matter of law and therefore were discharged under the intercreditor agreement, the court did not reach that issue. In fact, the court even showed sympathy for the senior lien creditors on this point, noting that the agreement requires "payment in full in cash" and asking: "How much more explicit can you get?" This specificity as to "payment in full" however, was not relevant because of the court's view of the narrowness of the lien subordination agreement, ultimately allowing significant distributions to and aggressive actions by the junior lien creditors.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.


| | | |
|---|---|---|
| **Donald S. Bernstein** | **212 450 4092** | **donald.bernstein@davispolk.com** |
| **Timothy Graulich** | **212 450 4639** | **timothy.graulich@davispolk.com** |
| **Marshall S. Huebner** | **212 450 4099** | **marshall.huebner@davispolk.com** |
| **Benjamin S. Kaminetzky** | **212 450 4259** | **ben.kaminetzky@davispolk.com** |
| **Elliot Moskowitz** | **212 450 4241** | **elliot.moskowitz@davispolk.com** |
| **Brian M. Resnick** | **212 450 4213** | **brian.resnick@davispolk.com** |
| **Damian S. Schaible** | **212 450 4580** | **damian.schaible@davispolk.com** |
| **Eli J. Vonnegut** | **212 450 4331** | **eli.vonnegut@davispolk.com** |
| **Aryeh Ethan Falk** | **212 450 4563** | **aryeh.falk@davispolk.com** |


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# TAB 6

**In re: BOSTON GENERATING, LLC, et al., [1] Debtors.**

1 The Debtors in these chapter 11 cases, along with the last four digits of each Debtor's federal tax identification number, include: Boston Generating, LLC (0631); EBG Holdings LLC (3635); Fore River Development, LLC (7933); Mystic I, LLC (0640); Mystic Development, LLC (7940); BG New England Power Services, Inc. (0476); and BG Boston Services, LLC (6921).

**Chapter 11, Case No. 10-14419**

**UNITED STATES BANKRUPTCY COURT FOR THE SOUTHERN DISTRICT OF NEW YORK**

**440 B.R. 302; 2010 Bankr. LEXIS 4335; 54 Bankr. Ct. Dec. 4**

**December 3, 2010, Decided**

**DISPOSITION:** The court approved the debtors' motion and authorized the debtors to enter into the APA they negotiated with the buyer.

**COUNSEL:** **[**1]** For Boston Generating, LLC, aka Sithe Boston Generating, LLC, aka Exelon Boston Generating, LLC, Debtor: Caroline A. Reckler, Latham & Watkins LLP, Chicago, IL; D. J. Baker, Latham & Watkins LLP, New York, NY.

For The Garden City Group, Inc., Claims and Noticing Agent: Jeffrey S. Stein, The Garden City Group, Inc., Melville, NY.

For Official Committee of Unsecured Creditors, Creditor Committee: Steven C. Reingold, Jager Smith P.C., New York, NY.

**JUDGES:** Shelley C. Chapman, United States Bankruptcy Judge.

**OPINION BY:** Shelley C. Chapman

**OPINION**

**[*306] OPINION GRANTING DEBTORS' MOTION SEEKING AUTHORITY TO SELL, PURSUANT TO 11 U.S.C. § 363, SUBSTANTIALLY ALL OF THE DEBTORS' ASSETS**

SHELLEY C. CHAPMAN
UNITED STATES BANKRUPTCY JUDGE

Before the Court is the Debtors' motion seeking authority to sell substantially all of the Debtors' assets, free and clear of liens, claims, and encumbrances to Constellation Holdings, Inc. ("Constellation") and to authorize the assumption and assignment of certain executory contracts and unexpired leases in connection with the sale, as well as certain other related relief (the "Sale Motion"). By the Sale Motion, the Debtors submit that they have a good business reason for selling their assets prior to **[**2]** confirmation of a plan and that they meet the standard articulated by the Second Circuit in *Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.)*, 722 F.2d 1063 (2d Cir. 1983), and in subsequent decisions of courts in this District.

Objections to the sale were filed by: (i) MatlinPatterson Global Advisers LLC ("Matlin"), one of the Second Lien Lenders (as defined below), (ii) Wilmington Trust FSB, as Second Lien Administrative Agent and Second Lien Collateral Agent under the Second Lien Credit Agreement (the "Second Lien Agent"), (iii) the Official Committee of Unsecured Creditors (the "UCC"), (iv) Algonquin Gas Transmission, LLC ("Algonquin"), and (v) other objectors whose objections were largely resolved prior to or during the hearing. CarVal Investors, LLC ("CarVal") and Fortress Investment Group, LLC ("Fortress"), whose affiliated funds own both First Lien Debt and Second Lien Debt (each as defined below), joined in the objections of the Second Lien Agent and Matlin. Additionally, numerous objections to assumption and assignment of executory contracts were filed, and these objections were either resolved or adjourned until December 7, 2010. The Court has been advised **[**3]** that the objection filed by Algonquin has also been resolved.

Specifically, Matlin and the Second Lien Agent have argued, *inter alia*, that the Debtors did not properly exercise their fiduciary duties in moving forward with the Sale Motion; the Second Circuit standard **[*307]** for approving sales of substantially all assets outside of a plan has not been met; section 363(f) of title 11 of the United States Code (the "Bankruptcy Code") has not been satisfied; and the Sale Transaction should be evaluated under an entire fairness standard.

The Debtors and the Special Committee (as defined below) responded to the objections. Credit Suisse AG, Cayman Islands Branch (the "First Lien Agent"), as First Lien Collateral Agent under the First Lien Credit and Guaranty Agreement (the "First Lien Credit Agreement") filed a statement in support of the Sale Motion. U.S. Power Generating ("USPG"), the Debtors' non-debtor ultimate parent, also filed a response to the objectors' submissions.

The Court requested additional briefing on Algonquin's objection and the Debtors, CarVal, Fortress, Constellation, and Algonquin filed additional submissions.

In addition to those declarations submitted and introduced in connection **[**4]** with the Bid Procedures Hearing (as defined below), the Debtors submitted the declarations of: (i) Jeff Hunter, Manager, Executive Vice President and Chief Financial Officer of the Debtors; (ii) Carsten Woehrn, Executive Director of J.P. Morgan Securities LLC ("JPM"); and (iii) Adrienne K. Eason Wheatley, member of Latham & Watkins LLP. The Second Lien Agent introduced the declaration of Judah Rose, Managing Director of ICF International, Inc. ("ICF"). Algonquin introduced the declarations of: (i) Greg McBride, the Vice President of Rates and Certificates of Spectra Energy Corp., Algonquin's parent, and (ii) Richard Paglia, Algonquin's Vice President of Marketing. Messrs. McBride and Paglia's declarations and testimony were the subject of a motion *in limine* filed by the Debtors which was subsequently withdrawn. Kevin M. Cofsky, Managing Director of Perella Weinberg Partners, LP ("Perella"), also submitted a declaration which was subsequently withdrawn.

Additional declarations were filed by (i) William Howard Wolf, member of the board of managers (the "Board") of the parent Debtor EBG Holdings LLC ("EBG") and the sole member of a special committee of the Board (the "Special Committee") **[**5]** and (ii) Islam (Sam) Zughayer, Managing Director and the head of the restructuring group at Berenson & Company, LLC ("Berenson"). Constellation filed the declaration of Dayan Abeyaratne, Constellation's Vice President of Corporate Strategy & Development, on the issue of its ability to provide adequate assurance of future performance with respect to the assumed contracts and in support of a finding that it meets the standard for a good faith purchaser.

Live testimony was given by Messrs. Abeyaratne, Cofsky, Hunter, McBride, Paglia, Rose, Woehrn, Wolf, and Zughayer.

The parties submitted deposition designations and counter-designations for: (i) Dayan Abeyaratne; (ii) Kevin Cofsky; (iii) Leslie Dedrickson, managing director for portfolio management at Constellation; (iv) Jeff Hunter; (v) Wesley Kern, Senior Vice President, Finance, of USPG; (vi) Scott Moresco, a tax partner at KPMG; [2] (vii) Greg McBride; (viii) Richard Paglia; (ix) Ryan Roberts, a director of Madison Dearborn Partners (a USPG equity owner); (x) Carsten Woehrn; (xi) William Howard Wolf; and (xii) Sam Zughayer. Approximately six volumes of exhibits were introduced, containing many dozens of trial exhibits.

2 KPMG served as **[**6]** tax advisors to the Debtors and to USPG prior to the Petition Date.

**[*308]** In addition, by agreement of the parties, the record of the hearing held on October 4-7 and on October 9, 2010 (the "Bid Procedures Hearing") and the Court's October 9, 2010 bench ruling with respect thereto (the "Bid Procedures Decision") have also been made part of the record of the evidentiary hearing held by this Court on November 17, 18, 19, 21, 22, and 23, 2010 to consider the sale of substantially all of the Debtors' assets (the "Sale Hearing").

**FINDINGS OF FACT**

After an evidentiary hearing, the Court makes the following findings of fact. [3]

> 3 The findings of fact and conclusions of law herein shall constitute the Court's findings of fact and conclusions of law pursuant to Bankruptcy Rule 7052, made applicable to this proceeding pursuant to Bankruptcy Rule 9014. To the extent any finding of fact later shall be determined to be a conclusion of law, it shall be so deemed, and to the extent any conclusion of law later shall be determined to be a finding of fact, it shall be so deemed.

**I. Background**

On August 18, 2010 (the "Petition Date"), each of the Debtors filed a voluntary petition for relief under chapter 11 of the **[**7]** Bankruptcy Code. The Debtors' cases are being jointly administered pursuant to an order dated August 20, 2010, and the Debtors continue to operate their respective businesses as debtors-in-possession pursuant to sections 1107 and 1108 of the Bankruptcy Code. The Debtors employ some 148 persons of whom 107 are members of the Utility Workers Union of America. Maintenance of the Debtors' facilities is primarily conducted by third-party vendors.

The Debtors operate power plants that provide wholesale electricity to the Boston area, and they own the third largest generation fleet in New England. The Debtors generate revenue by selling electricity, receiving capacity payments, and providing ancillary services. In order to manage the various risks and market price fluctuations inherent in the conversion of fossil fuels (primarily natural gas) into electricity, the Debtors utilize a variety of derivative instruments and other long-term contracts.

The Debtors' non-debtor ultimate parent, USPG, provides energy management and general asset management services to the Debtors. In addition to owning, indirectly, 100% of the Debtors' equity, USPG owns Astoria Generating ("Astoria"). Astoria owns power **[**8]** generation assets that provide wholesale electricity to the New York area. Astoria is not a Debtor.

As noted in the Declaration of Jeff Hunter in Support of the Debtors' Chapter 11 Petitions and First Day Pleadings, over the last several years, low fuel prices, eroding demand, and a significant surplus of supply have put downward pressure on margins in the energy, capacity, and ancillary service markets in New England. Additionally, a significant amount of new uneconomic supply is expected to come online over the next three to five years. The Debtors define "uneconomic supply" as supply that may be subsidized or is otherwise below a hypothetical market price. This new uneconomic supply, combined with eroding demand, has created a significant surplus of future capacity which is depressing market prices and reducing revenue.

The Debtors have approximately $2 billion in prepetition debt. The Debtors' operations are financed by two tranches of secured debt: (i) a $1.45 billion first lien term credit facility pursuant to the First Lien Credit Agreement, of which approximately $1.13 billion is currently outstanding (the "First Lien Debt," held by the "First Lien Lenders"), secured by first-priority **[**9]** liens on substantially all of the **[*309]** Debtors' assets (the "Collateral") and (ii) a $350 million second-lien term loan facility (the "Second Lien Debt," held by the "Second Lien Lenders"), secured by second-priority liens on the same Collateral. The Second Lien Lenders together with the First Lien Lenders may be referred to herein as the "Secured Parties." The Debtors also have approximately $422 million of unsecured debt at the parent-Debtor level, pursuant to a term-loan facility advanced to EBG (the "Mezzanine Facility"). Neither USPG nor Astoria is a guarantor of any of these facilities.

Although the Debtors' First Lien Credit Agreement, Second Lien Credit Agreement, and Mezzanine Facility were not in default prior to the Petition Date, given the Debtors' liquidity position and projected ongoing liquidity needs, the Debtors believed they had insufficient liquidity to continue to service their debt and fund ongoing operations.

The Debtors are participants in the electric energy

markets administered by ISO-New England ("ISO-NE"). ISO-NE is the regional transmission organization designated by the Federal Energy Regulatory Commission ("FERC"). ISO-NE administers the day-ahead and realtime **[**10]** energy markets as well as capacity and ancillary service markets in accordance with FERC's market rules. Pursuant to ISO-NE's rules, utilities that provide electricity to end-use customers must demonstrate that they have capacity equal to the peak load forecast plus a margin for any relevant period. These companies can fulfill their capacity obligation by buying forward contracts in the forward capacity market from the Debtors or their competitors. The objective of the forward capacity market is to purchase sufficient capacity for reliable system operation for a future year at competitive prices where all resources, both new and existing, can participate. Forward capacity prices are the most important component of the Debtors' asset value and are known several years in advance.

Current pricing in the forward capacity market points to flat or declining capacity revenue through 2014. The February 2008 auction for the 2010/2011 capacity year cleared at the regulatory floor price of $4.50 per kW-month. Prices in the second auction (for the 2011/2012 capacity year), the third auction (for the 2012/2013 capacity year), and the fourth auction (for the 2013/2014 capacity year) cleared at the **[**11]** regulatory administered floor of $3.60 per kW-month, $2.95 per kW-month, and $2.95 per kW-month, respectively. Certain of the parties who have objected to the Sale Transaction (as defined below) believe that pricing is not competitive and FERC will issue regulations at the end of the first quarter of 2011 that will increase prices. As Mr. Rose testified, regulatory changes may increase revenue after 2014 and revenues might increase substantially in 2018. However, removing the price floor could cause material future declines in revenue after 2014. There was substantial testimony regarding the pending FERC docket during the Bid Procedures Hearing; the Court's preliminary findings in the Bid Procedures Decision regarding the FERC docket insofar as it relates to the Debtors are specifically incorporated by reference herein and require no modification in light of evidence adduced during the Sale Hearing.

As a means to reduce their exposure to energy commodity price risk, the Debtors entered into accretive energy hedges. These hedges, which will expire on December 31, 2010, accounted for about 50% of the Debtors' earnings before interest, taxes, depreciation and amortization ("EBITDA") over **[**12]** the last eight quarters.

## [*310] II. The Debtors' Restructuring Efforts

The Debtors engaged in an eighteen-month long restructuring process which began over a year prior to the Debtors' August 18, 2010 petition date and eventually led to a heavily marketed sale for substantially all of the Debtors' assets. The process has involved a multitude of steps, a bevy of professionals, and enormous amounts of information exchange and diligence, not to mention extensive litigation.

In September 2008, in an effort to address issues with its consolidated balance sheet, USPG retained Perella as its financial advisor. USPG and the Debtors first attempted a balance sheet restructuring, including attempted issuance of new equity securities. In the middle of 2010, it became clear that a balance sheet restructuring was unlikely to be successful, and Perella signed a new engagement letter with the Debtors (and terminated its engagement with USPG) in June 2010. The Debtors determined that a sale of substantially all assets would be the best way to maximize the value of their assets. They retained JPM to run a sale process while Perella continued working on the Debtors' balance sheet restructuring and assisting on **[**13]** due diligence.

In late April 2010, JPM began an extensive marketing and sale process. It contacted 199 potential buyers (81 strategic and 118 financial) and distributed a confidential information memorandum to 36 of those parties (the "CIM Recipients"), requesting preliminary letters of interest by May 18, 2010. The Second Lien Lenders' financial advisor, Houlihan Lokey Howard & Zukin; their energy industry expert, Mr. Rose's firm ICF; and their legal advisors were fully engaged in this restructuring and sale process. The Debtors paid certain of the fees of the Second Lien Lenders' advisors in an attempt to foster a process in which a consensual transaction could be achieved. Ten CIM Recipients (the "Potential Purchasers") responded with preliminary letters of interest. The Debtors opted to pursue further discussion with six of the Potential Purchasers. These six Potential Purchasers received access to the Debtors' management, went on site visits, and received access to an extensive electronic data room. Two of the six Potential Purchasers submitted "final" bids, which were

accompanied by marked purchase agreements. The Debtors negotiated extensively with the two bidders. Through this **[**14]** negotiation, the Debtors were able to secure improved terms and conditions and achieve an approximately $100 million increase in the purchase price from the "final" bid.

On August 7, 2010, the Debtors and Constellation signed a pre-petition asset purchase agreement (the "Asset Purchase Agreement") for the sale of substantially all of the assets of the Debtors for $1.1 billion cash (the "Sale Transaction"). The $1.1 billion cash purchase price is subject to working capital adjustments. The Asset Purchase Agreement requires the Debtors to seek approval of a sale pursuant to section 363 of the Bankruptcy Code and to obtain the entry of a sale order by this Court no later than 90 days after the Debtors' Petition Date (which date has been subsequently extended by Constellation to November 24, 2010). Based on the Debtors' estimate, the net proceeds of the Sale Transaction combined with the Debtors' cash on hand will be sufficient to pay approximately 98.5% of the First Lien Debt but will leave no recovery for the Second Lien Debt or unsecured creditors.

On August 17, 2010, a group of First Lien Lenders who hold in excess of 50% of the outstanding first lien obligations under the First Lien **[**15]** Credit Agreement executed a sale support agreement with the Debtors. **[*311]** The First Lien Credit Agreement permits a sale of Collateral with the consent of over 50% of the First Lien Lenders (who are defined in the agreement as "Required Lenders"). Thus, the sale support agreement assured the Debtors that the First Lien Lenders would consent to the proposed sale even if they were not paid in full. By its terms, the sale support agreement permits the Debtors to pursue alternative transactions that the Debtors believe would result in a higher and better offer.

**III. The Debtors' Chapter 11 Cases, the FERC Proceedings, and the Post-Petition Sale Process**

On August 19, 2010, one day after the Petition Date, the Debtors filed the Sale Motion, seeking entry of (i) an order approving and authorizing (a) bid procedures in connection with the proposed sale of substantially all of their assets, (b) stalking horse bid protections, (c) procedures for the assumption and assignment of executory contracts and unexpired leases in connection with the sale, (d) the form and manner of notice of the sale hearing and (e) certain related relief; and (ii) an order approving and authorizing (a) the sale of substantially **[**16]** all of the Debtors' assets free and clear of claims, liens, liabilities, rights, interests and encumbrances, (b) the Debtors to enter into and perform their obligations under the Asset Purchase Agreement, (c) the Debtors to assume and assign certain executory contracts and unexpired leases, (d) the Transition Services Agreement and (e) related relief.

Concurrently with the filing of the Sale Motion, the Debtors and Constellation sought FERC approval of the proposed sale of the Debtors' power plants, including a power plant in Massachusetts owed by one of the Debtors, Fore River Development, LLC (the "Fore River Plant"), to Constellation pursuant to section 203 of the Federal Power Act, 16 U.S.C. § 824b (the "FPA"). Thus, on August 18, 2010, the Debtors and Constellation filed with FERC their Joint Application for Authorization of Disposition of Jurisdictional Facilities, Request for Waivers of Certain Filing Requirements, and Request for Shortened Comment Period and Expedited Consideration (the "203 Application").

On August 27, 2010, the Debtors filed the First Omnibus Motion of Debtors for Entry of Order Authorizing the Debtors to Reject Certain Executory Contracts *Nunc Pro Tunc* to **[**17]** Their Respective Notice Dates (the "Rejection Motion") seeking authorization to reject, among other executory contracts, the 2001 HubLine Service Agreement, dated as of January 31, 2001, between the Debtors and Algonquin (the "HSA"). The Debtors seek to reject the HSA because they believe, in their business judgment, that the HSA does not provide a substantial benefit to the estate and, moreover, imposes a burden on the estate.

On September 1, 2010, Algonquin filed its Motion for Withdrawal of Reference With Respect to the Rejection Motion (the "Motion for Withdrawal of Reference of Rejection Motion"), requesting that the United States District Court for the Southern District of New York (the "District Court") withdraw the reference of the Rejection Motion only with respect to the HSA to resolve an alleged conflict between federal bankruptcy law authorizing the rejection of executory contracts and federal energy law under the Natural Gas Act, 15 U.S.C. § 717 et seq. ("NGA") requiring FERC approval of the termination or amendment of natural gas transportation agreements.

On September 8, 2010, Algonquin filed with FERC

its Motion to Intervene and Protest of Algonquin Gas Transmission, **[*312]** **[**18]** LLC (the "FERC Protest") with respect to the 203 Application. In the FERC Protest, Algonquin argued, *inter alia*, that if FERC were to approve the 203 Application, which contemplates the sale of the Fore River Plant *without* the HSA, FERC would be using the exclusive delegation of authority granted by Congress under the FPA to preempt an equal but separate exclusive delegation of authority under the NGA in violation of the filed rate doctrine and the public interest. Algonquin also argued that any change or alteration by FERC of the HSA must be done only after notice and due process under the NGA, which has yet to be initiated with FERC.

On September 17, 2010, Algonquin filed its Motion to Withdraw the Reference with Respect to the Sale Motion (the "Motion for Withdrawal of Reference of Sale Motion") on grounds similar to the Motion for Withdrawal of Reference of Rejection Motion. The Motion for Withdrawal of Reference of Rejection Motion and Motion for Withdrawal of Reference of Sale Motion were assigned to the Honorable Denise L. Cote, United States District Judge.

On October 4-7 and on October 9, 2010, the Court held the Bid Procedures Hearing to consider approval of the bid procedures, **[**19]** approval of the stalking horse bid protections to Constellation, and other requested relief (the "Bid Procedures"). After substantial testimony and argument, on October 9, 2010, the Court issued the Bid Procedures Decision approving the relief requested. The Court found that the Debtors properly exercised their business judgment in moving forward with the sale process and seeking approval of the bid procedures because they believed that the sale process was the best way to maximize the value of their estates. On October 12, 2010, the Court entered an order approving the Bid Procedures and granting related relief.

After approval of the Bid Procedures, JPM contacted (i) the approximately 200 potential bidders it had contacted prepetition and (ii) over 40 additional potential bidders who had not been previously contacted. JPM aggressively sought out interested buyers and encouraged them to participate in the process. JPM oversaw an electronic due diligence data site with tens of thousands of pages of information. CarVal, Fortress, and Matlin, including their advisors, accessed some 36,306 documents in the data site. JPM facilitated the flow of information to and the answers to questions **[**20]** from Matlin and other Second Lien Lenders. JPM updated the data site during the post-petition auction process and responded to dozens of written questions posed by potential bidders. JPM set up bidder-specific data sites to post-bidder specific information that might compromise an individual bidder's competitive position if placed on the broader data site. Potential bidders received, at their election, daily emails announcing the availability of the new information as it was added to the data site.

On November 1, 2010, Judge Cote issued an Opinion and Order (the "November 1 Opinion") granting the Motion for Withdrawal of Reference of Rejection Motion and denying the Motion for Withdrawal of Reference of Sale Motion. The District Court withdrew the reference of the Rejection Motion because "[i]n order to decide the Rejection Motion, a court will have to decide whether Congress has, through the Bankruptcy Code, given the district court power to authorize the Debtors to reject the HSA, or if instead, doing so would run afoul of FERC's exclusive jurisdiction over filed rate contracts under the NGA." [4]

4 *In re Boston Generating, LLC, et al.*, 1:10-cv-06528-DLC, 2010 U.S. Dist. LEXIS 116073 (S.D.N.Y. 2010) (Docket No. 21) **[**21]** at 12.

**[*313]** In conjunction with the November 1 Opinion, Judge Cote issued an order to show cause (the "OSC") ordering Algonquin and the Debtors to show cause by noon on November 5, 2010 "why the Court should not transfer the Rejection Motion back to the Bankruptcy Court for it to decide the Rejection Motion pursuant to 11 U.S.C. § 365, on the condition that the Debtors must also obtain approval from FERC pursuant to the NGA to reject the HSA." [5]

5 *In re Boston Generating, LLC, et al.*, 1:10-cv-06528-DLC, 2010 U.S. Dist. LEXIS 120347 (S.D.N.Y. 2010) (Docket No. 22).

On November 4, 2010, the Board voted to establish the Special Committee [6] and appointed William Howard Wolf as its sole member. As discussed more fully in the Bid Procedures Decision, Mr. Wolf was the sole independent board member of EBG, and his vote was required by the Debtors' organizational documents before filing for bankruptcy to launch the 363 sale process. Mr. Wolf has several decades of experience with corporate

governance with large companies, and he was fully engaged with the Debtors and the process.

6 For purposes of this decision, the term "Special Committee" refers to actions taken by Mr. Wolf after November 4, 2010.

The Special Committee was delegated **[**22]** the full power of the Board to evaluate all possible options available to EBG to maximize the value of the Debtors' estates. Specifically, the Board resolution establishing the Special Committee delegates to the Special Committee the authority of the full Board to (i) review and evaluate a possible sale pursuant to section 363 of the Bankruptcy Code or other strategic alternative; (ii) discuss and negotiate possible restructuring alternatives with any party the Special Committee deemed or deems appropriate; (iii) approve a possible restructuring alternative, if appropriate; and (iv) assist with any other matter which could present an actual or potential conflict between the interests of EBG and its parent. As the sole member of the Special Committee, Mr. Wolf considered whether to proceed with the Sale Transaction.

The Board vested the Special Committee with authority to retain its own independent legal and financial advisors. Mr. Wolf selected Young Conaway Stargatt & Taylor, LLP as the Special Committee's independent legal counsel and Berenson as the Special Committee's independent financial advisor. In addition to taking advantage of the broad knowledge base of the Debtors' advisors, **[**23]** the Special Committee also received advice from its own independent advisors.

On November 9, 2010, the Debtors submitted an amendment ("Amendment No. 1") to the Asset Purchase Agreement, which contained certain revisions related to collective bargaining agreements and other employee matters. It also extended the parties' termination deadline in the Asset Purchase Agreement to January 14, 2011, in the event that the only outstanding unsatisfied closing condition is FERC approval. Lastly, it clarified language related to payment of the break-up fee upon consummation of an Alternative Transaction (as defined in the Asset Purchase Agreement) to eliminate certain potential drafting ambiguities that were discussed on the record at the Bid Procedures Hearing. In a supplemental objection filed on November 14, 2010, Matlin objected to the changes to the break-up fee provision in the Asset Purchase Agreement implemented by Amendment No. 1. It argued that the changes were overbroad and rendered the break-up fee payable in circumstances **[*314]** beyond those agreed to on the record at the Bid Procedures Hearing. The Debtors and Constellation agreed that Amendment No. 1 would not be enforceable to the extent **[**24]** that it exceeded the scope of the changes set forth on the record. Matlin concurred with this approach as resolving its concerns with respect to Amendment No. 1.

Per the Bid Procedures, "Qualified Bids" (which, as defined in the Bid Procedures, must, *inter alia*, (a) exceed the value of the Sale Transaction plus the break-up fee plus the $10 million bid increment, (b) not be conditioned on obtaining financing, and (c) include a $50 million good faith deposit) were due on or before November 13, 2010 at 12 p.m. (the "Bid Deadline") from parties desiring to participate in an auction for the sale of substantially all of the Debtors' assets. However, the Bid Procedures stated that, "Nothing herein shall preclude a bidder from submitting a competing bid in the form of a plan of reorganization and it being understood that such bid may be determined by the Debtors not to be a Qualified Bid." An auction, if needed, was scheduled for November 15, 2010 at 10 a.m.

On November 12, 2010, Judge Cote issued another order with respect to the Motion for Withdrawal of Reference of Rejection Motion (the "November 12 Opinion," and, together with the November 1 Opinion, the "District Court Opinions"). In this **[**25]** opinion, Judge Cote said, "In order to reject the [HSA], the Debtors must also obtain a ruling from FERC that abrogation of the contract does not contravene the public interest." [7] Judge Cote ordered that Fore River obtain a determination from FERC pursuant to the NGA whether it may reject the HSA. [8] Judge Cote also noted that, "[w]hether the bankruptcy court and FERC review the proposed rejection concurrently or serially is of no consequence." [9]

7 *In re Boston Generating, LLC, et al.*, 1:10-cv-06528-DLC, 2010 U.S. Dist. LEXIS 120347 (S.D.N.Y. 2010) (Docket No. 25) at 2.

8 *Id.* at 7.

9 *Id.*

On Saturday, November 13, 2010 at 3 p.m., the Special Committee reviewed the sole bid received, which was a proposal that had been submitted by Matlin. The Special Committee, with the assistance of its advisors and the Debtors' advisors, analyzed the value differences and qualitative differences between the Sale Transaction and

the Matlin proposal. After the receipt of the bid, the Special Committee (through his professionals and the Debtors' professionals) continued to provide diligence and feedback to Matlin on its plan proposal. The Debtors extended the Bid Deadline through November 15, 2010 in order to give Matlin feedback and to **[**26]** permit Matlin to improve on the clearly articulated shortcomings in the Matlin proposal. Mr. Wolf's lengthy and extremely detailed declaration filed in support of the Sale Transaction reflects an almost minute-by-minute account of what transpired in the critical days leading up to the scheduled auction on November 15. Mr. Wolf's account was largely unchallenged, and the Court adopts his declaration as an accurate record of the events that transpired and who participated. Mr. Wolf's declaration also identified with specificity numerous reasons why the Matlin "proposal" could not be considered a "Qualified Bid," let alone a confirmable plan, and he explained these points in more detail in his live testimony. I find his testimony and declaration credible; it plays an important role in my decision.

Matlin's objection questions the Debtors' decision to move forward with the Sale **[*315]** Transaction rather than with Matlin's proposal. After Matlin made its initial submission to the Debtors on November 13, Matlin continued to amend its proposal until the Debtors determined not to hold a formal auction on November 15. Based on representations and evidence introduced at the Sale Hearing, Matlin's bid **[**27]** appears to have continued to evolve even after November 15. Matlin's proposal, as reflected in Exhibits 518 and 520 and as supplemented at the Sale Hearing, in summary, involves recapitalizing the Debtors with $700 million of debt (which amount was eventually increased to $750 million), $200 million of accreting preferred stock invested by Matlin, and several hundred million shares of common equity (par value $1.00 per share) as well as certain warrants that would be distributed to holders of First Lien Debt and Second Lien Debt. Matlin represents that the enterprise value of the Debtors, as reflected in its proposal, is some $1.35 billion. Matlin's proposal includes a so-called "cash out option" for the stock distributed to the holders of the First Lien Debt at up to 75 cents on the dollar. As a result, Matlin's proposal lacks a fully backstopped offering that would pay 100 cents on the dollar in cash to First Lien Lenders who did not wish to accept a portion of their recovery in stock.

The Debtors' liquidity position was a hotly contested issue during the Bid Procedures Hearing as well as during the Sale Hearing. Mr. Hunter testified at the Bid Procedures Hearing and likewise at the **[**28]** Sale Hearing that the Debtors' liquidity was an issue of concern to him. His judgment was and remains that the Debtors will run out of cash in April 2011. The Debtors' liquidity analysis annexed as Exhibit A to the Supplemental Declaration of Jeff Hunter in Support of the Sale Motion and the Debtors' latest variance report, all introduced into evidence, bear out this conclusion. The objecting parties did not cross-examine Mr. Hunter with respect to his projection that the Debtors will run out of cash in April 2011. They did, however, elicit testimony from Mr. Hunter confirming the already-established fact that, although he took certain steps to extend the Debtors' liquidity runway, he did not take steps to obtain DIP financing for the Debtors. Based on the entirety of the record on the issue of the Debtors' liquidity, the Court finds that the Debtors would have a negative cash balance as of April 2011 if they were to continue to operate and did not receive an additional infusion of cash, through DIP financing or otherwise.

The Court conducted the evidentiary portion of the Sale Hearing on November 17, 18, 19, 21, and 22, and heard six hours of closing arguments on November 23, 2010.

**IV. [**29] Ultimate Facts**

Based on all of the foregoing, the Court makes the following findings of ultimate facts:

> 1. There is a good business reason for proceeding with the Sale Transaction as opposed to pursuing the formulation and confirmation of a chapter 11 plan.
>
> 2. There is an articulated business justification for proceeding with the Sale Transaction now.
>
> 3. The Sale Transaction reflects an appropriate exercise of business judgment and fulfillment of the Debtors' fiduciary duties.
>
> 4. There is no viable higher and better existing alternative to the Sale Transaction.

**DISCUSSION**

The various objections filed by the objecting parties break down into a number **[*316]** of more or less discrete categories. The Court considers them in turn.

**I. Standing**

The First Lien Agent has argued that neither the Second Lien Agent nor any Second Lien Lender has standing to object to the Sale Motion. The Second Lien Agent asserts that it and various objecting Second Lien Lenders have standing to argue, *inter alia*, that the Debtors are selling their assets at an inopportune time; that pending FERC regulatory reforms are likely to increase the value of the Debtors' assets in the first quarter of 2011; and that the timing of this **[**30]** 363 sale process was motivated by an improper purpose of securing tax benefits for the non-Debtor parent, USPG. The Second Lien Agent argues the Debtors cannot satisfy the Second Circuit's test for selling substantially all of their assets outside of a plan. As a threshold matter, the Court must make a determination on the question of standing.

As detailed above, prior to the commencement of these chapter 11 cases, the operations of the Debtors were financed by two tranches of secured debt: (i) a $1.45 billion credit facility secured by first-priority liens on the Collateral, and (ii) a $350 million second-lien term loan facility secured by subordinated second-priority liens on the same Collateral, as well as (iii) unsecured mezzanine debt, in the amount of $422 million, pursuant to a term-loan facility advanced to EBG.

In connection with the issuance of the First Lien Debt and the Second Lien Debt, (i) the Debtors, (ii) the First Lien Agent on behalf of itself and the First Lien Lenders, and (iii) the Second Lien Agent on behalf of itself and the Second Lien Lenders entered into a December 21, 2006 Collateral Agency and Intercreditor Agreement (the "Intercreditor Agreement"), a dense, **[**31]** sixty-five page document governing the relationship between and among the Secured Parties.

Broadly speaking, the Intercreditor Agreement establishes the priority of the liens on the Collateral and the Secured Parties' rights and duties relative to each other. Other than the lien subordination provisions of the Intercreditor Agreement, section 3 of the Intercreditor Agreement is perhaps the most critical substantive provision of the Intercreditor Agreement and is at the heart of the dispute between the First Lien Lenders and the Second Lien Lenders with respect to the issue of standing.

Section 3.1(b)(i) of the Intercreditor Agreement provides, *inter alia*, that:

> Until the Discharge of First Lien Obligations has occurred, whether or not any Insolvency or Liquidation Proceeding has been commenced . . . . the First Lien Collateral Agent, at the written direction of [First Lien Lenders holding a majority of the First Lien Debt], shall have the exclusive right to enforce rights, exercise remedies . . . and make determinations regarding the release, sale, disposition or restrictions with respect to the Collateral without any consultation with or the consent of the Second Lien Collateral Agent **[**32]** or any Second Lien Secured Party . . . . provided that the Lien securing the Second Lien Obligations shall remain on the proceeds of such Collateral released or disposed of subject to the relative priorities described in Section 2.1[].

Section 3.1(c) of the Intercreditor Agreement states:

> . . . Without limiting the generality of the foregoing, unless and until the Discharge of First Lien Obligations has occurred, except as expressly provided in Sections 3.l(a)(i), 3.1 (g) and 6.3(b) and **[*317]** this Section 3.1(c), the *sole right* of the Second Lien Collateral Agent, the Second Lien Administrative Agent, and any other Second Lien Secured Party with respect to the Collateral is to hold a Lien on the Collateral pursuant to the Second Lien Collateral Documents for the period and to the extent granted therein and to receive a share of the proceeds thereof, if any, after the Discharge of First Lien Obligations has occurred. (emphasis added).

Section 3.1(c) is subject to certain exceptions, including

section 3.1(g), which sets forth rights retained by the Second Lien Lenders, including the right to vote on a plan of reorganization (section 3.1(g)(v)) and the right to assert any "right and interest available **[**33]** to unsecured creditors" in a manner not inconsistent with the terms of the Intercreditor Agreement (section 3.1(g)(iv)).

In connection with the Bid Procedures Hearing, the First Lien Agent asserted that the Second Lien Agent and the Second Lien Lenders lacked standing to object to the portion of the Sale Motion seeking approval of the Bid Procedures. On October 4, 2010, the Court ruled that the Second Lien Agent had standing to object to the Bid Procedures, noting that "[t]he plain language of the Intercreditor Agreement says the seconds are silent in certain circumstances, but I do not read any express prohibition against objection to bidding procedures anywhere in the intercreditor agreement." The Court distinguished *In re Ion Media Networks, Inc.*, 419 B.R. 585 (Bankr. S.D.N.Y. 2009) and *In re Erickson Ret. Cmtys., LLC*, 425 B.R. 309 (Bankr. N.D. Tex. 2010). The Court's ruling on October 4, 2010, as specifically stated at the hearing, was limited only to the issue of standing to object to the Bid Procedures. The Court noted that, if necessary, it would address the issue of standing to object the Sale Transaction at a later date.

The Sale Hearing began on November 17, 2010 with **[**34]** lengthy and thoughtful oral arguments by counsel for the First Lien Agent and counsel for the Second Lien Agent on the issue of whether the provisions of the Intercreditor Agreement precluded the Second Lien Lenders from objecting to the Sale Transaction. Additional briefing on the issue was filed by the First Lien Agent and the Second Lien Agent.

During oral argument, counsel for the First Lien Agent and the Second Lien Agent "stipulated" to the conclusion that the actions taken (or to be taken) by the First Lien Agent in connection with the proposed sale are not an "exercise of remedies" for the purposes of the Intercreditor Agreement; the specific action in question is the consent of the First Lien Agent pursuant to section 363(f)(2) of the Bankruptcy Code. A colloquy ensued as to the whether the Court was required to accept such a "stipulation" or whether the Court was free to make its own determination as to whether a consent pursuant to section 363(f)(2) was an "exercise of remedies" under the Intercreditor Agreement, which appeared to the Court to be a mixed question of fact and law. The Second Lien Agent urged the Court to defer to the view of the counterparties to the Intercreditor **[**35]** Agreement on the meaning of the term. The Second Lien Agent also argued that both parties had waived any argument that there was an exercise of remedies. The reason for the Second Lien Agent's position, while not anywhere explained, seems clear: to avoid the express prohibition in section 3.1(d)(i) of the Intercreditor Agreement, which states that "each Second Lien Secured Party . . . agrees not to take any action that would hinder any exercise of remedies under the First Lien Documents **[*318]** or is otherwise prohibited hereunder including any sale, lease, exchange, transfer or other disposition of the Collateral, whether by foreclosure or otherwise." The reason for the First Lien Agent's position is less clear and the Court will refrain from speculation on this point. Moreover, during closing argument, counsel for the First Lien Agent informed the Court that it was the position of the First Lien Agent that the consent of the First Lien Lenders, though given, was not required pursuant to section 363(f)(2) and that the Sale Transaction could be approved without such consent pursuant to section 363(f)(5).

While the term "exercise of remedies" is used in numerous provisions of the Intercreditor **[**36]** Agreement, it is not defined anywhere in the Intercreditor Agreement. For the purposes of this decision, I accept the Secured Parties' stipulation that there has been no exercise of remedies by the First Lien Agent. However, absent this stipulation, I may have concluded that consent under section 363(f)(2) is an exercise of the rights afforded to a secured creditor and is thus an exercise of remedies. *See, e.g., In re Chrysler LLC*, 405 B.R. 84, 101-02 (Bankr. S.D.N.Y. 2009). This may have altered my conclusion herein regarding standing and whether or not the objections asserted by the Second Lien Agent and the Second Lien Lenders were a violation of the Intercreditor Agreement.

The stipulation that there is no "exercise of remedies" renders sections 3.1(a) and 3.1(d)(i) inapplicable to the standing issues before the Court. The crux of the issue thus becomes the meaning of sections 3.1(b) and 3.1(g) of the Intercreditor Agreement.

There is little dispute that the Intercreditor Agreement is not a model of clarity with respect to the narrow issues before the Court. The parties all but acknowledged that, were they starting from scratch, the

Intercreditor Agreement would be drafted differently. **[**37]** No arguments were made or evidence adduced as to the intent of the Secured Parties and, accordingly, my analysis is limited to interpreting the text of the specific provisions of the Intercreditor Agreement.

Interpreting text requires some discussion and understanding of context. If one were to explain, in lay terms, the purpose and function of an intercreditor agreement between first lien parties and second lien parties, the explanation would include the notion, as the First Lien Agent stated, that first lien lenders would be "in the driver's seat" when it came to decisions regarding collateral. [10] In other words, or to use a different metaphor, the second lien lenders agree not to use their subordinated lien as an offensive weapon against first lien lenders with respect to collateral. Notwithstanding their agreement to be subordinated, second lien lenders do retain certain rights under a typical intercreditor agreement, including the right to appear and be heard in a bankruptcy case as unsecured creditors. This right includes making arguments that an unsecured creditor would have the standing (and the economic interest) to assert and those arguments that are not otherwise expressly **[**38]** waived by the intercreditor agreement. *See Ion Media*, 419 B.R. at 595.

10 Statement of Credit Suisse AG, Cayman Islands Branch, in Support of the Debtors' Bidding Procedures and Sale Motion (Docket No. 247) at 10.

The Intercreditor Agreement is an enforceable agreement under section 510(a) of the Bankruptcy Code to the extent that it is a subordination agreement. The Court should not and will not interpret it in a way that re-drafts or re-negotiates the Secured Parties' bargained-for **[*319]** rights. If a secured lender seeks to waive its rights to object to a 363 sale, it must be clear beyond peradventure that it has done so. Under New York law, the First Lien Lenders must point me to some provision that reflects an express or intentional waiver of rights. *See Golfo v. Kycia Associates, Inc.*, 45 A.D.3d 531, 845 N.Y.S.2d 122, 124 (N.Y. App. Div. 2007) (compiling cases); Intercreditor Agreement section 9.11 (stating New York law applies). For example, in the May 2010 issue of the *Business Lawyer*, the American Bar Association published the *Report of the Model First Lien/Second Lien Intercreditor Agreement Task Force* which contained a Model Intercreditor Agreement, including commentary (the "ABA **[**39]** Model Intercreditor"). [11] In section 6.2, the ABA Model Intercreditor contains an express waiver of the right to object to a sale pursuant to section 363 of the Bankruptcy Code. It states,

> Second Lien Agent, as holder of a Lien on the Collateral and on behalf of the Second Lien Claimholders, will not contest, protest, or object, and will be deemed to have consented pursuant to section 363(f) of the Bankruptcy Code, to a Disposition of Collateral free and clear of its Liens or other interests under section 363 of the Bankruptcy Code if First Lien Agent consents in writing to the Disposition *provided* that....(i) the liens of the second lien creditors attach to the proceeds of such disposition to the extent so ordered by the court, (ii) the net cash proceeds are applied to reduce the first lien obligations permanently, and (iii) the second lien creditors will not be deemed to have waived any right to bid in connection with such disposition.

*Id.* at 858-59, 858 n.67. The language in the Intercreditor Agreement falls short of such clarity.

11 *See* 65 Bus. Law. 809.

The First Lien Agent argues that "[s]ection 3.1(b)(i) makes two points abundantly clear: first, that decisions as to whether the Collateral **[**40]** should be sold free and clear of liens are the exclusive province of the First Lien Agent; and second, that the Second Lien Lenders' protection comes not from overruling determinations by the First Lien Agent, but from the attachment of their liens to the proceeds of the sale." [12] The First Lien Agent notes that section 3.1(b)(i) is conjunctive and gives the First Lien Agent "the exclusive right to enforce rights, exercise remedies . . . *and* make determinations regarding the release, sale, disposition or restrictions with respect to the Collateral" (emphasis added). [13]

12 Statement of Credit Suisse AG, Cayman Islands Branch, in Support of the Debtors' Bidding Procedures and Sale Motion (Docket No. 247) at 8.

13 *Id.* at 10.

The Second Lien Agent argues that, "[a]ll [Section 3.1(b)(i)] means is that the First Lien Lenders do not need to consult with the Second Lien Lenders, which has been obviously the case before and after the Petition Date. But it simply does not prohibit the Second Lien Agent and the Second Lien Lenders from taking action on their own including objecting to a 363 Sale which the First Lien Lenders support." [14] The Second Lien Agent argues, **[*320]** "[i]n light of the absence of an **[**41]** explicit prohibition against filing a 363 sale objection under the Intercreditor Agreement and the fact that general unsecured creditors can object to the Sale Transaction, the conferral under Section 3.1(g) of the Intercreditor Agreement to the Second Lien Agent and the Second Lien Lenders of rights of unsecured creditors must be viewed as granting such parties authorization to file the Objection." [15]

14 Objection of Second Lien Agent to Motion of the Debtors for Entry of an Order Approving and Authorizing (a) the Sale of Substantially All of the Assets of the Debtors Free and Clear of All Claims, Liens, Liabilities, Rights, Interests and Encumbrances; (b) the Debtors to Enter Into and Perform Their Obligations Under the Asset Purchase Agreement; (c) the Debtors to Assume and Assign Certain Executory Contracts and Unexpired Leases; (d) the Transition Services Agreement; and (e) Related Relief (Docket No. 397) at 11.

15 *Id.* at 10.

Section 3.1(g)(iv) of the Intercreditor Agreement allows the Second Lien Agent to "file any pleadings, objections, motions or agreements which assert rights or interests available to unsecured creditors of the Loan Parties arising under any Insolvency or Liquidation **[**42]** Proceeding or Applicable non-Bankruptcy Law, in each case not inconsistent with the terms of this Agreement . . . ." The Second Lien Agent argues the Sale Transaction cannot be approved in accordance with section 363(b) of the Bankruptcy Code. Its objections (other than its arguments relating to section 363(f)) assert rights and interests available to unsecured creditors. Moreover, nothing in the Intercreditor Agreement specifically prohibits the Second Lien Agent from objecting to the Sale Transaction. The Second Lien Agent is not asserting that it has the right to direct the First Lien Agent, nor is it requesting that the First Lien Agent consult with the Second Lien Agent.

Although I believe it goes against the spirit of the subordination scheme in the Intercreditor Agreement to allow the Second Lien Lenders to be heard and to attempt to block the disposition of the Collateral supported by the First Lien Agent, I am now (as I was at the Bid Procedures Hearing) constrained by the language of the Intercreditor Agreement. After extensive briefing and oral argument as well as detailed review of the Intercreditor Agreement, the Court finds no provision which can be read to reflect a waiver **[**43]** of the Second Lien Agent's right to object to a 363 sale motion, either in its capacity as a Secured Party or in its capacity as an unsecured creditor. Here, the perfect storm of a poorly drafted agreement, the ill-defined scope of section 3.1(g)'s retained right to object as an unsecured creditor, and the fact that, pursuant to the Secured Parties' own stipulation, there is "no exercise of remedies" leads me to conclude that the Second Lien Agent and Second Lien Lenders have standing to object to the 363 sale.

This reading of the Intercreditor Agreement is, to say the least, a very close call. While not dispositive, additional facts that enter into the Court's analysis include: (i) the fact that the issue here is a 363 sale of substantially all of the Debtors' assets outside of a plan of reorganization, which, if approved, will effectively deprive the Second Lien Lenders of the opportunity to vote, in an economically meaningful way, on a plan of reorganization [16] and (ii) as the Court found at the Bid Procedures Hearing, the Second Lien Lenders are on the "cusp" of a recovery and are not engaging in the type of obstructionist behavior identified by the Court in *Ion Media*.

16 *See, generally,* **[**44]** *(Bank of Am. v. North LaSalle St. L.P. (In re 203 North LaSalle St. Psp.)*, 246 B.R. 325, 331 (Bankr. N.D. Ill. 2000) (stating "§ 510(a), in directing enforcement of subordination agreements, does not allow for waiver of voting rights under § 1126(a)") and *Lionel*, 722 F.2d at 1070 (discussing the benefits of a plan process).

As will become apparent, however, this is a somewhat hollow victory for the Second Lien Lenders, inasmuch as I have determined, after giving full consideration to the arguments and evidence presented by **[*321]** the Second Lien Agent and the objecting Second Lien Lenders, to approve the Sale Transaction.

**II. Sale of the Debtors' Assets under Section 363**

In order to determine that the Sale Transaction can be approved, the Court must determine, consistent with well-established Second Circuit law, that section 363 of the Bankruptcy Code can be utilized for the sale of substantially all of the Debtors' assets before confirmation of a plan of reorganization; that the necessary showings for approval of any section 363 sale have been made; that the proposed sale is not a "sub rosa" plan; that the section 363 sale does not run afoul of the District Court Opinions; and that various additional **[**45]** objections asserted by the Second Lien Agent and the objecting Second Lien Lenders; Algonquin; and the UCC have been resolved or addressed.

**(a) Utilization of Section 363**

Section 363(b) of the Bankruptcy Code provides, in relevant part, that, after notice and a hearing, a debtor-in-possession "may use, sell, or lease, other than in the ordinary course of business, property of the estate." 11 U.S.C. § 363(b). In *Lionel*, the Second Circuit was called upon to determine whether, pursuant to section 363(b) of the Bankruptcy Code, a major asset of a bankruptcy estate could be sold "out of the ordinary course of business and prior to acceptance and outside of any plan of reorganization." *See Lionel*, 722 F.2d at 1066.

In *Lionel*, the Second Circuit reviewed the history of a court's administrative power under the Bankruptcy Code to authorize asset sales. Under the Bankruptcy Act, sales prior to confirmation had been limited to wasting assets, situations where the assets were physically perishable or likely to deteriorate in price. *Id.* at 1067. The Bankruptcy Reform Act of 1978 introduced section 363(b), which does not constrain a court with strict limitations on its ability to authorize a sale **[**46]** of assets and does not confine the use of section 363(b) to emergency situations only. *Id.* at 1069.

In its decision, the Second Circuit articulated a standard for determining when to authorize a section 363(b) sale "prior to acceptance and outside of any plan of reorganization" which strikes a balance between a debtor's ability to sell its assets and the right of a creditor to an informed vote on a plan of reorganization. The standard recognized some flexibility in allowing the court to do "what is best for the estate" while simultaneously reflecting the Second Circuit's view that section 363 does not grant a bankruptcy judge "carte blanche." *Id.*

The *Lionel* Court concluded that there has to be some articulated business justification, other than appeasement of a particular creditor, for the use, sale or lease of a debtor's property outside of the ordinary course of business. *Id.* at 1070. Thus, a court rendering a section 363(b) determination must "expressly find from the evidence presented . . . a good business reason to grant such application." *Id.* at 1071. This "good business reason" standard was articulated again in *In re Chateaugay Corp. (LTV Corporation)*, 973 F.2d 141, 143 (2d Cir. 1992), **[**47]** in which the Second Circuit affirmed a sale of substantially all assets of a debtor where the debtor articulated risk of loss of value of the assets.

In *Lionel*, the Second Circuit found that, in making its determination as to whether to authorize a sale of assets outside of a plan pursuant to section 363 of the Bankruptcy Code, a court should consider all of the "salient factors pertaining to the proceeding" and "act to further the **[*322]** diverse interests of the debtor, creditors and equity holders." *Lionel*, 722 F.2d at 1071. The Court then set forth a nonexclusive list of factors (the "*Lionel* Factors") to guide a court in its consideration of the issue, which are the following:

o the proportionate value of the asset to the estate as a whole,

o the amount of elapsed time since the filing,

o the likelihood that a plan of reorganization will be proposed and confirmed in the near future,

o the effect of the proposed disposition on future plans of reorganization,

o the proceeds to be obtained from the disposition vis-a-vis any appraisals of the property,

o which of the alternatives of use, sale or lease the proposal envisions, and

o whether the asset is increasing or decreasing in value.

*Id.* In his decision **[**48]** in *In re General Motors Corp.*, 407 B.R. 463, 490 (Bankr. S.D.N.Y. 2009) ("*GM*"),

Judge Gerber also suggested that courts consider the following additional factors (the "GM Factors"), in appropriate cases:

> o Does the estate have the liquidity to survive until confirmation of a plan?
>
> o Will the sale opportunity still exist as of the time of plan confirmation?
>
> o If not, how likely is it that there will be a satisfactory alternative sale opportunity, or a stand-alone plan alternative that is equally desirable (or better) for creditors? and
>
> o Is there a material risk that by deferring the sale, the patient will die on the operating table?

In *GM*, Judge Gerber noted that each of the *Lionel* Factors, and the additional ones he suggested, support the ultimate questions that the *Lionel* Court identified: Is there an "articulated business justification" and a "good business reason" for proceeding with the sale without awaiting the final confirmation of a plan? *See id*. In addition, per *Lionel*, a court must consider if those opposing the sale produced evidence that would rebut the articulated business justification. *Lionel*, 722 F.2d at 1071.

The Court finds that the Debtors have an articulated business **[**49]** justification and a good business reason for selling their assets pursuant to section 363. I am going to review those *Lionel* and *GM* Factors that were central to this dispute and bear most heavily on my analysis.

***Lionel*** **Factors**:

**1. The Likelihood That a Plan of Reorganization Will Be Proposed and Confirmed in the Near Future**

There is no basis on which the Court can find that a plan will be proposed and can be confirmed in the near future, let alone by April 30, 2011, which is the date on which the Debtors project they will run out of cash.

Matlin's proposed plan, which is reflected on a term sheet submitted on November 13 and clarified on November 14, is not confirmable. The Matlin "plan" has the support of no constituency, indeed no party, other than Matlin -- not even CarVal and Fortress, who helped lead the charge of the Second Lien Lenders at the Bid Procedures Hearing. The Court finds persuasive the views of Mr. Wolf as to why the Matlin plan would be very difficult to confirm and does not reflect a commercially reasonable course of action for the Debtors. In his declaration, Mr. Wolf expressed the following concerns about the Matlin proposal:

> [(a)] no lock-up of Fortress and CarVal; **[**50]** (b) no consent of the First Lien **[*323]** Lenders to the plan or even to take equity in partial satisfaction; (c) no plan support agreement from [Matlin]; (d) no consent to a priming [or *pari passu*] DIP loan; (e) DIP Financing subject to [Matlin]'s determination that there is a demonstrated need for financing; (f) unclear whether the proposed DIP financing is sufficient [to meet the Debtors' liquidity needs]; (g) no plan, just a plan term sheet; . . . (j) the view of the financial advisors to both the Special Committee and the Debtors, respectively, that [Matlin] had not demonstrated that the [Matlin] proposal was feasible. [17]

Mr. Zhugayer, the independent financial advisor for the Special Committee, testified that it would have been "commercially reckless" to abandon the Constellation bid and embark on a free fall bankruptcy in order to give Matlin an opportunity to secure support from additional creditors. The Court agrees with Mr. Zhugayer.

> 17 Declaration of William Howard Wolf in Support of Debtors' Motion for Sale of Substantially All of the Debtors' Assets (Docket No. 465) at ¶ 89.

There has been no evidence adduced as to any other prospective plan of reorganization.

**2. The Proceeds to Be [**51] Obtained from the Disposition vis-a-vis Any Appraisals of the Property**

The value of the Debtors' assets is at the very heart of this case. Since the beginning of the case, the Second Lien Agent and objecting Second Lien Lenders have argued that the Debtors are not getting fair market value for their assets. While there are no appraisals *per se* of the Debtors' assets, several data points indicate the potential value of their assets. First, there is the Sale Transaction,

which represented the highest and best offer after a robust, open, and fair process in which substantial marketing and due diligence materials were widely distributed. Second, there is the bid submitted by the runner-up bidder in the pre-petition auction ("Bidder B"), whose bid was very close in amount to Constellation's bid. Third, there is Matlin's plan proposal, which Matlin asserts reflects a value of $1.35 billion. And finally, there is the valuation opinion of Mr. Judah Rose, which reflects a $1.38 billion discounted cash flow ("DCF") valuation of the Debtors' assets. Based on the entirety of the record, the Court finds that the Sale Transaction is the best determination of the value of the Debtors' assets.

**(a) The [**52] $1.1 Billion Cash Sale Transaction**

There is a great deal of evidence that the JPM sale process, both pre-petition and post-approval of the Bid Procedures, was well-executed and robust. No evidence was adduced during the Sale Hearing that alters the Court's finding in the Bid Procedures Decision that the sale process was properly executed to obtain the highest price. [18] If anything, the robust post-petition marketing improved the overall sale process. JPM was knowledgeable about those parties that might be interested in purchasing the Debtors' assets. Information about the Debtors' business and **[*324]** regulatory upside was appropriately highlighted. Because the Debtors' sale process was heavily marketed and potential buyers were presented with abundant information, the sale process reflects a true test of value.

18 Mr. Carsten Woehrn, the lead banker on the JPM team that ran the sale process, was contemporaneously engaged on the sale process that was being conducted for the Comparable transaction discussed *infra*. The Second Lien Lenders argue that this dual representation undercut and impaired the Debtors' sale process. While not ideal, the fact that Mr. Woehrn was "wearing two hats" does not **[**53]** persuade the Court that the Debtors' sale process was negatively affected, or that JPM's discharge of its duties to the Debtors was compromised.

**(b) Bidder B's Pre-Petition Bid**

Bidder B was actively engaged in the pre-petition auction process. Bidder B is a sophisticated party who has the industry, regulatory, and financial expertise to evaluate the Debtors' assets and has sufficient capital to purchase the Debtors' assets. Bidder B made a cash bid very similar to, though slightly lower than, the Constellation bid. During the Bid Procedures Hearing, the Second Lien Lenders argued that the Debtors should have done more to continue the bidding process after Bidder B declined to top Constellation's bid. The existence and amount of Bidder B's bid provides another data point regarding the value of the Debtors' assets.

**(c) Matlin's Plan Proposal**

Matlin asserts that its proposal reflects an implied valuation of $1.35 billion. The record does not contain any evidence that supports this valuation. Among other things, no attempt was made to value the common stock component of the Matlin proposal. The most that can be said, based on the record of the Sale Hearing, is that Matlin purports to be willing **[**54]** to invest $250 million of cash to purchase preferred stock junior to $750 million of new secured debt in the reorganized Debtors.

Additionally, no other Second Lien Lender has agreed to participate in Matlin's proposal. CarVal and Fortress, who separately engaged ICF and Mr. Rose to advise them, have not signed on as co-proponents of the Matlin proposal. The lack of committed support for the Matlin proposal casts serious doubt on the implied value Matlin ascribes to it. *See, e.g., In re Chemtura Corp.*, 439 B.R. 561, 2010 Bankr. LEXIS 3773, *123, 2010 WL 4272727, *16 (Bankr. S.D.N.Y. Oct. 21, 2010) (finding that lack of interest in proposals at certain values lends support to conclusion that value is too high).

**(d) The Rose Valuation**

Judah Rose, Managing Director of ICF and the Second Lien Agent's industry expert, was an impressive witness. It cannot be gainsaid that Mr. Rose is a leading expert on the energy industry generally and, in particular, on electric power. His declaration reflects a valuation that is detailed, thorough, and professional. Mr. Rose concluded, based on a DCF analysis, that the Debtors' assets are worth $1.38 billion.

There are numerous critical assumptions that underlie **[**55]** Mr. Rose's DCF valuation. First, there are economic assumptions that form the basis of the appropriate discount rate. Second, there are regulatory and economic assumptions about the Debtors' future revenue.

Small changes in assumptions result in substantial differences in value. *See In re Chemtura Corp*., 2010 Bankr. LEXIS 3773, 2010 WL 4272727 at *6. For example, in order to perform his DCF analysis, Mr. Rose formed a view of the discount rate. He estimated the discount rate using the Capital Asset Pricing Model with an implied weighted after-tax cost of capital of 10.4%. Key economic assumptions that underlie his DCF valuation include, *inter alia*: the risk-free rate of return, nominal equity rate of return, nominal debt rate of return, and debt-to-equity ratio. Other than the risk-free rate of return, which is commonly dictated by U.S. Treasury prices, the other variables involve substantial judgment on which reasonable minds can disagree. The evidence demonstrates that a small **[*325]** variation in the assumptions causes a large swing in value.

The Debtors highlight how Mr. Rose's revenue projections far exceed the Debtors' own projections, particularly with respect to projected forward capacity prices. Mr. Rose testified **[**56]** that the most important determinant of value is the forward capacity price. Forward capacity prices are currently low because capacity far exceeds demand. Where capacity exceeds demand, power generators are economically willing to sell at their marginal cost. However, economically rational power generators will not build new plants until the forward capacity price equals the cost of new entry. Assuming demand growth and steady capacity, at some point, demand will grow to exceed capacity and a new power plant will need to be built (a point Mr. Rose refers to as "Equilibrium"). Equilibrium is the point at which Mr. Rose estimates prices will increase from the current price of approximately $3/kW-month (with a corresponding 2011 projected EBITDA of $69 million) to approximately $16/kW-month (with a corresponding 2018 projected EBITDA of $283 million).

The key variable in determining Equilibrium is demand growth. Mr. Rose believes that for the years 2012, 2013, and 2014, ISO-NE summer peak demand growth will be 2.8%, 2.8%, and 1.9%, respectively. ISO-NE's projections for the same period are 1.6%, 1.2%, and 1.3%, respectively. These seemingly small differences cause multi-year shifts in **[**57]** the Equilibrium date. Shifting Equilibrium by one year changes the value of the Debtors' assets by approximately $100 million.

Mr. Rose believes ISO-NE's demand growth projections are wrong. He testified that ISO-NE has historically under-forecasted demand, while his forecasts have been historically correct. Nonetheless, ISO-NE uses its forecasts to set prices and policy. Mr. Rose posits that when actual future demand proves ISO-NE wrong, prices will be even higher, as ISO-NE will have failed to encourage appropriately timed new entry into the market.

Equilibrium is also accelerated by decreasing capacity. Mr. Rose believes that older power plants that currently sell capacity into the forward capacity market will be retired in the near future. He posits that increasingly onerous environmental regulation will make older polluting plants uneconomical and they will thus be retired. One of these plants is Mystic 7 and is owned by the Debtors. Thus, a buyer of the Debtors' assets will be able to influence market capacity. The retirement of these plants will further decrease capacity.

Mr. Rose's demand and price projections are heavily contingent on a wide range of factors, including future **[**58]** regulatory reform, the timing of regulatory reform, demand for electricity (which is, in itself, contingent on broad economic factors), environmental regulation, retirement of competing plants, cost of plant operation, energy costs, construction costs, and other costs of new entry. Changes to these variables result in dramatically different forward capacity prices and dramatic swings in value.

Given Mr. Rose's firm view that the Debtors' assets are worth $1.38 billion, what is the explanation for the quarter billion dollar gap between his valuation and the amount of the Sale Transaction? Simply put, Mr. Rose believes he is right and the market is wrong. It is generally accepted, however, that absent a showing that there has been a clear market failure, the behavior in the marketplace is the best indicator of enterprise value. *See, e.g., In re Chemtura Corp*., 2010 Bankr. LEXIS 3773,2010 WL 4272727 at **[*326]** *16 n.106; *Bank of America Nat. Trust and Sav. Ass'n v. 203 North La Salle Partnership*, 526 U.S. 434, 457, 119 S. Ct. 1411, 143 L. Ed. 2d 607 (1999) (acknowledging "the best way to determine value is exposure to a market" rather than a determination by a bankruptcy judge); *In re Granite Broad. Corp*., 369 B.R. 120, 143 (Bankr. S.D.N.Y. 2007) ("there **[**59]** is no dispute that in many circumstances the best evidence of value is what a third party is willing to pay in an arm's length transaction"); *VFB LLC v. Campbell Soup Co*., 482 F.3d 624, 633 (3d. Cir. 2007)

("[a]bsent some reason to distrust it, the market price is 'a more reliable measure of the stock's value than the subjective estimates of one or two expert witnesses.'" (citation omitted)). Mr. Zughayer echoed this view in his testimony during the Sale Hearing, stating, "the market is very efficient . . . as long as you go to a broad enough swathe of potential buyers, the market will tell you what the asset is worth." As Chief Judge Gonzalez noted in *Chrysler*, "the true test of value is the sale process itself." *In re Chrysler LLC*, 405 B.R. at 98.

Mr. Rose posits that the market failure, in this case, is the failure to understand or anticipate future regulatory changes. His analysis "assumes the value of the power plants is the value realizable via a sale process that adequately accommodates the expected reforms of the ISO-NE capacity market. These reforms are currently being conducted by [FERC] . . . . FERC is scheduled to [issue its reform order] before March 1, 2011 . . . . The **[**60]** goal is to provide adequate information to the set of potential purchasers of the EBG plants [on] the expected impacts of the forthcoming FERC Order." [19] Mr. Rose explains the difference between the $1.1 billion Sale Transaction and his valuation by stating, "First, the sale occurred before the market participants, especially the marginal buyer, had time to properly consider the impacts of the FERC reforms . . . . Second, Boston Generating and its professionals failed to provide adequate information about the potential increased revenues of the plant due to the fast moving reform process." [20] The Court disagrees with Mr. Rose on these critical points, for the following reasons.

19 Declaration of Judah Rose, dated November 15, 2010 at ¶ 15. The Declaration of Judah Rose was admitted into evidence at the Sale Hearing.

20 *Id*. at ¶ 26.

First, the Debtors and their professionals did provide adequate information to potential bidders about the possibility of increased revenues that could result from FERC reforms. JPM's management presentation presented to bidders clearly highlight regulatory upside, specifically stating that "[p]roposed modifications to Forward Capacity Market . . . provide potential **[**61]** upside." [21] The record at the Bid Procedures Hearing also includes detailed testimony and documentary evidence regarding potential regulatory developments elicited by Algonquin's counsel. Interested parties, both strategic and financial -- and including Bidder B -- were sophisticated and experienced investors and industry participants who had the financial and regulatory expertise to analyze the public FERC docket.

21 Exhibit 41 (Sale Hearing) at p. 11.

Second, although armed with unfettered access to Mr. Rose's knowledge and expertise, CarVal and Fortress did not bid on the Debtors' assets. Mr. Rose was retained by the Second Lien Agent, CarVal, and Fortress during the sale process. The First Lien Agent introduced email correspondence between CarVal and Fortress, on the one hand, and Mr. Rose, on the **[*327]** other hand, in which CarVal and Fortress: (i) discuss bidding on the Debtors' assets, (ii) receive Mr. Rose's views on the very regulatory issues Mr. Rose posits that the market misunderstands, and (iii) demonstrate a high level of knowledge about the FERC issues, including issues specific to the Boston power market discussed extensively in Mr. Rose's testimony. Thus, potential bidders with **[**62]** sufficient capital and demonstrated interest had actual knowledge of the key regulatory issues identified by Mr. Rose. They chose not to top Constellation's bid. [22]

22 *See In re Granite Broad. Corp*., 369 B.R. at 140-141, noting that, in appropriate circumstances, "'[p]eople who must back their beliefs with their purses are more likely to assess the value of the [asset] accurately than are people who simply seek to make an argument.'" (quoting *In re Central Ice Cream Co*., 836 F.2d 1068, 1072 n. 3 (7th Cir. 1987)); *In re Chemtura Corp*., 2010 Bankr. LEXIS 3773, 2010 WL 4272727 at *16 n. 110 (same); *In re Central Ice Cream Co*., 836 F.2d at 1072 n. 3 ("[a]stute investors survive in competition; those who do not understand the value of assets are pushed aside. There is no similar process of natural selection among expert witnesses and bankruptcy judges.").

In the Court's view, contrary to Mr. Rose's opinion, there was no market failure. Parties did obtain and process relevant information. In response to a direct question from the Court, Mr. Rose could not explain why no bidders (including his own clients) would pay more than $1.1 billion for the Debtors' assets. He reasoned that they did not understand the regulatory **[**63]** and economic environment, or that the market did not have the time (or the ability) to fully digest the complexities of the regulatory environment. In sum, Mr. Rose seems to

be of the view that it was unlikely that anyone understood the issues other than him.

Lastly, Mr. Rose (and the Second Lien Lenders) touted the allegedly most comparable plant (the "Comparable") in support of his valuation. The Comparable's facility is similar to the Debtors' combined cycle plants in certain respects, as articulated by Mr. Rose, but it is also different in certain ways identified by Mr. Rose and in ways of which Mr. Rose was not aware. At the Sale Hearing, Mr. Rose conceded that power plants are not commodities, and his valuation explicitly states that comparable transactions are not the best way to value power plants. While the Comparable provides another data point, its existence does not change the Court's conclusion regarding the value of the Debtors' assets; certain confidential testimony given by Mr. Rose regarding the Comparable also does not change the Court's conclusion. [23]

> 23 There was no evidence presented on which the Court could base a conclusion that Mr. Rose can accurately predict market **[**64]** outcomes. In order to draw a conclusion as to the predictive validity of Mr. Rose's model, the Court would require evidence of how often the model accurately predicted market outcomes and how often it did not. In other words, there should be no cherry-picking of the data, i.e., pointing to one piece of data that supports a particular conclusion, while ignoring other data that may contradict that conclusion. *See* Oxford English Dictionary Online (November 2010), available at www.oed.com (defining "cherry-pick" as "to choose selectively (the most beneficial or profitable items, opportunities, etc.) from what is available"). At best, Mr. Rose's view of the Comparable reflects a piece of anecdotal evidence of questionable applicability to the Sale Transaction.

Finally, it bears noting that Mr. Rose's valuation was presented *after* the Bid Deadline. The Second Lien Lenders, however, had retained Mr. Rose during the pre-petition marketing process; Mr. Rose attended the Bid Procedures Hearing; and Mr. Rose indicated that he would have been willing to testify to value at the Bid Procedures Hearing, if asked. I do not fault Mr. Rose for the timing of his valuation. **[*328]** However, there is no credible **[**65]** explanation for why his valuation was introduced so late in the process. The Second Lien Agent apparently made a purposeful decision not to bring Mr. Rose's valuation forward until the thirteenth hour. Here, where the Second Lien Lenders have relentlessly complained about the Debtors' process, it is worth noting how they chose to conduct themselves on this critical issue.

Based on the entirety of the evidence, the Court finds that the market price, represented by the Sale Transaction, is the best valuation for the Debtors' assets.

### 3. Whether the Asset is Increasing or Decreasing in Value

In *Lionel*, the Second Circuit stated that this factor is to be the most important one, *see Lionel*, 722 F.2d at 1071; I find that it favors the proposed sale of the Debtors' assets. The Debtors' liquidity in 2010 allowed them to engage in a robust marketing process and to position their assets for sale well ahead of the projected point in time when they would be perceived to be a distressed seller. In light of the time between negotiating a new transaction and obtaining FERC approval, the Debtors' negotiating leverage will decrease if they are forced to sell their assets under duress arising from liquidity **[**66]** issues. Decreased leverage inevitably leads to a lower price, worse terms, or both.

Mr. Rose asserted his belief that delay increases the value of the Debtors' assets because it will increase clarity on future regulatory reform. [24] The Court disagrees. This argument was extensively explored at the Bid Procedures Hearing. The Court's findings in the Bid Procedures Decision still stand, and, as discussed *infra*, the value of the Debtors' assets may indeed have already declined.

> 24 According to Mr. Rose, this occurs for three reasons. First, any delay allows for improvements in the information provided to the market, especially if a delay extends the sale past March 1, 2011, the expected timing for the completion of the FERC regulatory reform process. Second, there might be additional power plant sales transactions in the interim which might provide information on the value. Third, the prices for capacity and energy are forecasted to increase over time given the expected reforms, and, as one approaches the date of this market improvement and reduced regulatory uncertainty, the large amount of discounting in Mr. Rose's DCF

analysis is lessened.

***GM* Factors**:

**1. Does This Estate Have the Liquidity [**67] to Survive Until Confirmation of a Plan**

Mr. Hunter projects that, if the Debtors continue to operate through 2011, they will run out of cash on or about April 30, 2011. This testimony was credible and consistent with his testimony at the Bid Procedures Hearing and confirms the Debtors' business judgment that they are liquidity-constrained and will have a negative cash position as of April 2011.

Certain objectors, including Matlin and the Second Lien Agent, argue that the Debtors have sufficient cash to operate until confirmation of a plan, which includes either a sale or a stand-alone restructuring. The Court disagrees. It is not reasonable to believe that these Debtors, in light of their current liquidity situation and capital structure, can confirm a plan without a great deal of litigation, and they certainly cannot confirm a plan in the near future. Given the costs and time associated with confirming a plan under these circumstances, I find that the Debtors do not have the liquidity to survive until confirmation of a plan.

**2. Will the Sale Opportunity Still Exist As of the Time of Plan Confirmation**

There is no evidence that the Sale Transaction will remain available, and the **[*329]** Second **[**68]** Lien Agent concedes that it "probably" will not exist at the time a plan is confirmed. Constellation can terminate the Asset Purchase Agreement if the Court does not enter a sale order reasonably satisfactory in form and substance to Constellation on or before November 24, 2010. *See In re General Motors Corp*., 407 B.R. at 491 (discussing approval of the *Adelphia* section 363 sale where intercreditor disputes made it impossible to confirm a plan in time to save the sale opportunity). Moreover, evidence was presented that natural gas prices have declined since August 7, 2010 and (all other things being equal) this decline decreased the value of the Debtors' assets. Should Constellation remain interested in buying the Debtors' assets, there can be no assurance (and it seems highly unlikely) that it would continue to agree to pay $1.1 billion in cash for the assets. The Second Lien Lenders bemoan the fact that Bidder B did not submit a topping bid for the Debtors' assets. Bidders routinely move on to the next transaction when it suits their interests to do so. It is a real possibility that Constellation may move on as well.

The fact that the Sale Transaction probably will not exist at the **[**69]** time of a plan confirmation -- whenever that might occur -- weighs in favor of approving the Sale Transaction.

**3. How Likely Is It that There Will Be a Satisfactory Alternative Sale Opportunity, or a Stand-Alone Plan Alternative That Is Equally Desirable (or Better) for Creditors**

As discussed above, the record reflects that, on the Bid Deadline, Matlin tendered a "proposal" to the Debtors. The infirmities of the proposal were identified and discussed with Matlin as reflected in the declaration filed by Mr. Wolf. In addition, both Mr. Wolf and Mr. Hunter testified that the Matlin proposal does not reflect a confirmable plan of reorganization. The Court agrees. No other potential bidder submitted a Qualified Bid to the Debtors by the Bid Deadline which would lead me to conclude that an equally desirable or better alternative exists now or will materialize in the future.

**4. Is There a Material Risk That, by Deferring the Sale, the Patient Will Die On the Operating Table**

The evidence presented by the Debtors leads the Court to conclude that, if the Debtors were to abandon the Sale Transaction (deferral not being a realistic option), there is a material risk that, although the Debtors may not **[**70]** "die," their condition would significantly deteriorate. The Debtors do not have sufficient liquidity to continue operating without DIP financing, and, even if they were to obtain such financing, there is no guarantee that they would be able to obtain a different purchaser with a higher and better offer during the period in which financing remains intact. As the Court observed in the Bid Procedures Decision, if the Debtors were to wait until they were severely cash-constrained, there well could be degradation in the value of their assets simply because buyers may perceive that the Debtors needed to sell the assets immediately.

For all of the foregoing reasons, the Court concludes that there exists an articulated business justification and a good business reason to grant the Sale Motion now and not wait for confirmation of a plan of reorganization.

**(b) Compliance with Standards for Approval of Section 363 Sales**

Having concluded that the requisite articulated business justification and good **[*330]** business reason exist for the Sale Transaction, the Court now must determine whether the routine requirements for section 363 sales, and appropriate exercise of the business judgment rule, have been satisfied. **[**71]** Specifically, in addition to determining that the Debtors have complied with the business judgment rule, the Court must be satisfied that (i) proper notice has been given to all creditors and interested parties; (ii) the proposed sale price is fair and reasonable; and (iii) the purchaser is proceeding in good faith. *See, e.g., In re General Motors Corp.*, 407 B.R. at 493-94.

The Court is satisfied that each of these factors has been met. First, the Debtors provided appropriate notice of the sale to all interested parties. Second, consistent with the Court's findings herein, the proposed purchase price is fair and reasonable. The Debtors conducted a robust marketing process, and, despite testimony otherwise as to the potential value of the Debtors' assets, the Debtors received no higher and better offers.

I next turn to the question of whether the purchaser, Constellation, has acted in good faith. The Court finds that, both for the purpose of approval of the sale and for the purpose of the protections provided by section 363(m) of the Bankruptcy Code, Constellation is a good faith purchaser. No party has questioned Constellation's good faith in this process, and the evidence establishes **[**72]** that the negotiations between Constellation and the Debtors were conducted with integrity and at arms' length.

Consistent with the Court's Bid Procedures Decision, I again find that the Debtors have satisfied the business judgment rule. The business judgment rule entails "(1) a business decision, (2) disinterestedness, (3) due care, (4) good faith, and (5) according to some courts and commentators, no abuse of discretion or waste of corporate assets." *In re General Motors Corp.*, 407 B.R. at 495 (citation omitted).

Both Matlin and the Second Lien Agent have, in essence, argued that the Debtors have not exercised due care or good faith in proposing the current Sale Transaction. Matlin in effect argues that the Debtors are pursuing a federal foreclosure at the sole request of the First Lien Lenders. Matlin further argues that the Debtors have abrogated their fiduciary duties by failing to abandon the Sale Transaction to continue to negotiate the plan of reorganization proposed by Matlin. The Court disagrees. To the contrary, as Chief Judge Gonzalez noted in *Chrysler*, "to suggest that the Debtors should have pursued proposals that could not have been consummated . . . is to suggest that **[**73]** the Debtors should have breached their fiduciary duty." *In re Chrysler LLC*, 405 B.R. at 105.

The Debtors, in discharging their fiduciary obligations, must balance the interests of all creditors. *See In re Integrated Resources*, 147 B.R. 650, 658 (S.D.N.Y. 1992). In the Bid Procedures Decision, the Court found that the Debtors discharged their fiduciary duties to all creditors in good faith and satisfied the business judgment standard. Nothing has come to light since that decision, including the new evidence adduced by the Second Lien Lenders regarding the tax implications and timing of the sale process via-a-vis the interests of USPG and its equity holders, that causes the Court to change its determination in that regard. For the reasons articulated herein, the Court finds that the Debtors have demonstrated that the Special Committee's decision to move forward with the Sale Transaction now is a valid exercise of business judgment and that each of the factors of the business judgment test have been met.

**[*331] (b) "Sub Rosa" Plan**

The Second Lien Agent and objecting Second Lien Lenders contend that, by proposing the Sale Transaction, the Debtors have proposed the implementation of a forbidden "sub **[**74]** rosa" plan. The Court finds that they have not.

Caselaw in this Circuit and this District recognizes that "the debtor and the Bankruptcy Court should not be able to short circuit the requirements of Chapter 11 for confirmation of a reorganization plan by establishing the terms of the plan 'sub rosa' in connection with a sale of assets." *See In re General Motors Corp.*, 407 B.R. at 495 (citing *In re Iridium Operating LLC*, 478 F.3d 452, 466 (2d Cir. 2007)); *see also In re Chrysler LLC*, 405 B.R. at 97. Here, the proposed sale of the Debtors' assets is not a "sub rosa" plan of reorganization. The Debtors' assets are simply being sold; the First Lien Lenders will receive most of the proceeds in accordance with their lien priority; and remaining consideration will be subsequently distributed under a plan. As the Court has

held, the proposed Sale Transaction has a proper business justification and is not calculated to evade the plan confirmation process.

### III. Sale Free and Clear Pursuant to Section 363(f)

Section 363(f) of the Bankruptcy Code authorizes a debtor to sell property under section 363(b) "free and clear of any interest in such property of an entity other than the estate" if one of **[**75]** the following conditions is satisfied:

> 1) applicable nonbankruptcy law permits the sale of such property free and clear of such interest;
>
> 2) such entity consents; [25]
>
> 3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
>
> 4) such interest is in bona fide dispute; or
>
> 5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

11 U.S.C. § 363(f). The Second Lien Agent argues that none of the five conditions of section 363(f) has been satisfied. [26] **[*332]** The Debtors and the First Lien Agent argue that the Court can nonetheless approve the Sale Transaction under section 363(f)(3), or alternatively, under section 363(f)(5). The Court finds that both sections 363(f)(3) and section 363(f)(5) are satisfied.

> 25 While the First Lien Agent has consented to the Sale Transaction, *see* Statement of Credit Suisse AG, Cayman Islands Branch, as First Lien Agent, in Further Support of Debtors' Sale Motion (Docket No. 440) at 22, it takes the position that it is not, in doing so, exercising remedies as that term is used in the Intercreditor Agreement. Moreover, the Second **[**76]** Lien Agent apparently concedes that, if the First Lien Agent were exercising remedies in respect of the Collateral and releasing such Collateral, then the Collateral securing the liens of the Second Lien Agent would similarly be released. *See* Objection of Second Lien Agent to Motion of the Debtors for Entry of an Order Approving and Authorizing (a) the Sale of Substantially All of the Assets of the Debtors Free and Clear of All Claims, Liens, Liabilities, Rights, Interests and Encumbrances; (b) the Debtors to Enter Into and Perform Their Obligations Under the Asset Purchase Agreement; (c) the Debtors to Assume and Assign Certain Executory Contracts and Unexpired Leases; (d) the Transition Services Agreement; and (e) Related Relief (Docket No. 397) at 15 n.11 (citing section 5.1(a) of the Intercreditor Agreement). The First Lien Agent further argues that section 5.1 of the Intercreditor Agreement is irrelevant and points instead to section 3.1(b)(i) as authority for the view that the Second Lien Agent's lien can be released incident to the consent of the First Lien Agent even in the absence of an exercise of remedies. The Court need not decide this deemed consent issue inasmuch as it **[**77]** finds that sections 363(f)(3) and 363(f)(5) are satisfied.
>
> 26 If the Court were to have held that the Second Lien Agent did not have standing or had standing only to object as an unsecured creditor, the Second Lien Agent arguably would not be able to assert its 363(f) objection.

#### (a) Section 363(f)(3)

The Second Lien Agent argues that the Sale Transaction cannot satisfy the requirements of section 363(f)(3) with respect to the liens of the Second Lien Lenders. In support of its position, the Second Lien Agent primarily relies on *Clear Channel Outdoor, Inc., v. Knupfer (In re PW, LLC)*, 391 B.R. 25 (9th Cir. B.A.P. 2008) ("*Clear Channel*"). *Clear Channel* interpreted the term "value," as used in section 363(f)(3), to refer to the face amount of the lien. Accordingly, the Second Lien Agent argues that, in order to satisfy section 363(f)(3), the proceeds of the Sale Transaction must exceed the aggregate amount of the First Lien Debt and the Second Lien Debt, which amounts to approximately $1.45 billion.

I decline to follow *Clear Channel*; rather, on the whole, the Court finds cases such as *In re Beker Industries Corp*., 63 B.R. 474 (Bankr. S.D.N.Y. 1986) to be more persuasive than *Clear Channel* **[**78]** in their interpretations of a less than perfect statutory provision. As this Court held in *Beker Industries*, section 363(f)(3)

should be interpreted to mean that "the price must be equal to or greater than the aggregate *value* of the liens asserted against it, not their *amount*." *Id.* at 476 (emphasis added). [27]

27 Admittedly, the reasoning of *Beker* is not free from doubt inasmuch as the words "equal to" do not, in fact, appear in section 363(f)(3). The key to *Beker*, however, is its focus on the value of the asserted liens, as opposed to their amount, and its recognition that Congress, in enacting the Bankruptcy Code, consistently focused on protecting the value of a lienholder's collateral and ensuring that a lienholder would not be deprived of its rights in collateral without appropriate compensation. Such is the case here, where a robust sale process, if consummated, will lead to sale proceeds being distributed in accordance with lien priority.

The "value" of a lien is to be determined by reference to section 506(a) -- that is, it is the amount by which the lienholder's claim is actually secured. *See Beker*, 63 B.R. at 475; *see also United Sav. Ass'n of Texas v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365, 372, 108 S. Ct. 626, 98 L. Ed. 2d 740 (1988) **[**79]** ("The phrase 'value of such creditor's interest' in § 506(a) means 'the value of the collateral.'" (citations omitted)). As this Court previously held, the best evidence of the value of the Debtors' assets is the $1.1 billion Constellation bid. Based on Mr. Hunter's testimony, the proceeds of the Sale Transaction may be insufficient to pay the First Lien Debt in full; if that is the case, then the Second Lien Lenders' claims are not secured. Under *Beker* and the many decisions of other Bankruptcy Courts following its reasoning, I find that section 363(f)(3) is satisfied. To hold otherwise would effectively mean that most section 363 sales of encumbered assets could no longer occur either (a) absent consent of all lienholders (including those demonstrably out of the money) or (b) unless the proceeds of the proposed sale were sufficient to pay the face amount of all secured claims in full. If section 363(f)(3) and (as discussed below) section 363(f)(5) are read in the manner suggested by the Second Lien Lenders, it seems unlikely that a Court, under any circumstance, could approve a non-consensual section 363 sale. As both a practical matter **[*333]** and a matter of statutory construction, that **[**80]** cannot be the case. It is hard to imagine that Congress intended to so limit a debtor's power to dispose of encumbered assets, particularly where such disposition otherwise satisfies the requirements of section 363(b).

**(b) Section 363(f)(5)**

The Second Lien Agent argues that the Debtors have not met their burden to prove that the Second Lien Lenders could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of their liens. It relies on *Clear Channel*, where the Court held that (i) the fact that a lender could be satisfied with money in respect of credit extended and (ii) the existence of cramdown under section 1129(d) did not mean there were legal or equitable proceedings that could compel satisfaction of a junior lien for less than payment in full. *Clear Channel*, 391 B.R. at 45-47. As noted above, this Court declines to follow *Clear Channel*. Section 363(f)(5) does not require that the sale price for the property exceed the value of the interests. As recognized in a post-*Clear Channel* decision from a Bankruptcy Court in the Ninth Circuit, the existence of judicial and nonjudicial foreclosure and enforcement actions under state law can satisfy section 363(f)(5). **[**81]** *See In re Jolan, Inc.*, 403 B.R. 866, 870 (Bankr. W.D. Wash. 2009). [28] Numerous legal and equitable procedures exist by which the Second Lien Lenders could be forced to accept less than full payment of the Second Lien Debt. [29] Thus, the Court finds that because the Second Lien Lenders could be compelled under state law to accept general unsecured claims to the extent the sale proceeds are not sufficient to pay their claims in full, section 363(f)(5) is satisfied.

28 *See also* Frank A. Oswald and Andy Winchell, "*Missing the Forest for the Trees in § 363: How the Ninth Circuit's Bankruptcy Appellate Panel Neglected the Big Picture in the Clear Channel Decision*" No. 4 Norton Bankr. L. Adviser 2 (April 2009).

29 Under New York law, a junior lienholder (either in a foreclosure of real property or of collateral under the Uniform Commercial Code) is entitled to nothing more than the surplus cash generated in a sale. *See, e.g.*, N.Y. U.C.C. §§ 9-608, 9-615; *see also* N.Y. Real Prop. Acts. Art. 13. Similar laws exist in Massachusetts.

**IV. Objections of the Official Committee of Unsecured Creditors**

The UCC argues that if the Sale Transaction is

approved, the proceeds should be placed in escrow pending **[**82]** the expiration of the UCC's challenge period. The proposed sale order provided for the distribution of substantially all the proceeds to the First Lien Lenders to pay down the First Lien Debt, but it also provided for a holdback of funds sufficient to cover the alleged amount of certain claims the UCC may seek standing to assert pursuant to *In re STN Enterprises*, 779 F.2d 901, 904 (2d Cir. 1985) and its progeny. The Sale Transaction proceeds withheld will ultimately fund distributions under a plan of liquidation. The objections of the UCC have thus been addressed.

**V. Additional Objections**

**(a) Entire Fairness**

Matlin argues that an entire fairness standard, rather than a business judgment standard, should be applied to the Sale Transaction because, *inter alia*, members of the Debtors' Board, other than Mr. Wolf, were affiliated with USPG (the Debtors' non-debtor ultimate parent). Matlin alleges that those Board members stood to gain financially from tax benefits flowing to USPG from the sale of the **[*334]** Debtors' assets. The essence of Matlin's argument is that the Debtors' sales process was "tainted" because the Debtors' USPG-affiliated board members had "personal and economic allegiances to **[**83]** entities other than the Debtors." Matlin thus argues that an entire fairness standard is applicable to the Sale Transaction. In addition, Matlin urges that the "belated constitution" of the Special Committee with the power to make the ultimate decision to move forward with the Sale Transaction is insufficient to "overcome entire fairness." [30]

30 Objection of MatlinPatterson Global Advisers LLC to the Motion of the Debtors for Entry of an Order Approving and Authorizing the Sale of Substantially All of the Assets of the Debtors Free and Clear of Claims, Liens, Liabilities, Rights, Interests and Encumbrances (Docket No. 404) at ¶¶ 2, 26, 33.

Matlin argues that "when management is tainted by conflicts of interest, Delaware law imposes a heavy burden on them to justify their decisions as entirely fair" and that, per the decision in *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983), in order to satisfy the "entire fairness" standard, the Debtors need to demonstrate both fair process and fair price. [31]

31 *Id.* at ¶ 25.

Contrary to Matlin's assertions, the Court finds that the Debtors' USPG-affiliated Board members did not have personal and economic allegiances to entities other than the Debtors **[**84]** that infected their decisions regarding disposition of the Debtors' assets. Substantial testimony and deposition designations were introduced, both at the Bid Procedures Hearing and the Sale Hearing, that revealed, not surprisingly, that the Debtors and USPG engaged in tax planning. This tax planning focused on what other actions could be taken to produce the optimal tax results in the event of a 2010 sale of the Debtors' assets. Absent some other tax event (e.g., a deconsolidation or liquidation) the Sale Transaction will produce certain "negative" tax consequences. Matlin and the Second Lien Agent specifically argue that the timing of the Sale Transaction was motivated by securing tax benefits for USPG. The Court does not agree. The record does not support such a finding. Mr. Hunter, for example, stated that USPG would have been equally happy from a tax perspective to close the Sale Transaction in 2010 or 2011; indeed, under some tax scenarios, it may have been better to close the Sale Transaction in 2011. The documents, deposition designations, and testimony adduced by the Second Lien Agent on this point fail to convince the Court that there was a conflict regarding the timing of **[**85]** the sale process that infected the decision of the Board, or that the Board acted based on personal or economic allegiances to entities other than the Debtors.

Mr. Hunter testified that the timing of the Sale Transaction was motivated by concerns about the Debtors' liquidity and by advice rendered to the Debtors by their advisors concerning market conditions. The Debtors' Board, including those Board members affiliated with USPG, determined to sell the Debtors' assets in 2010 because they believed it would lead to the highest and best recovery for creditors and not for any improper purpose.

Finally, as to the actions of the Special Committee, the Court has already found that the Special Committee made an informed and reasonable choice to move forward with the Sale Transaction. The Court's conclusions in the Bid Procedures Decision regarding Mr. Wolf's active engagement, knowledge, and experience were, if anything, bolstered by the testimony at the Sale Hearing. The Special Committee **[*335]** received

independent advice after the Bid Procedures were approved that assisted it in responding to post-petition bids. The Special Committee's approval of the Sale Transaction provides "belt and suspenders" **[**86]** to an otherwise supportable decision of the Debtors' Board.

Accordingly, an entire fairness standard does not apply here. Additionally, even if an entire fairness standard were applicable, I find that the sale process and price are fair, for the reasons stated above.

**(b) Distribution of "Amounts Due" to the Second Lien Agent**

Under the distribution terms of the proposed sale order, substantially all of the Sale Transaction proceeds will be distributed immediately to the First Lien Agent and the First Lien Lenders. The proposed sale order did not reserve for "amounts due" to the Second Lien Agent as such term is used in section 4.1 of the Intercreditor Agreement.

The First Lien Agent and Second Lien Agent have disagreed about the interpretation of section 4.1 of the Intercreditor Agreement. Section 4.1, if applicable, directs that all "amounts due" to the First Lien Agent and the Second Lien Agent be paid before any interest or principal to First Lien Lenders. The First Lien Agent asserts that section 4.1 does not apply in the instant case because there has been no "exercise of remedies." The Second Lien Agent argues that section 4.1 applies to all distributions of Collateral.

The Court declines **[**87]** to determine in this decision what are essentially disputed priority rights between the First Lien Lenders and the Second Lien Lenders. Such decisions are more appropriately rendered during the plan process, or via adversary proceeding between the Secured Parties. *See, e.g., Contrarian Funds, LLC v. Westpoint Stevens Inc. (In re Westpoint Stevens Inc.)*, 333 B.R. 30, 51-52 (Bankr. S.D.N.Y. 2005). The Debtors should establish a reserve funded from the Sale Transaction proceeds in an amount that reasonably estimates the alleged "amounts due" to the Second Lien Agent (including fees and expenses of counsel and advisors), pending agreement by the Secured Parties or further order of the Court on this issue.

**CONCLUSION**

After having given due consideration, among other things, to the factors set forth in *Lionel* and in *General Motors*, the Court finds that all relevant standards have been established to grant the relief requested by the Debtors. Further, the Court finds that (i) the Sale Transaction is consistent with the District Court Opinions and the Bankruptcy Code, (ii) the Sale Transaction does not implement a "sub rosa" plan; (iii) the assets in the Sale Transaction can be sold free and **[**88]** clear of liens, claims, interests, and encumbrances pursuant to section 363(f) of the Bankruptcy Code; and (iv) the protections of a good faith purchaser pursuant to section 363(m) shall apply to Constellation.

The Sale Motion is granted in its entirety, and the Debtors' entry into and performance under and in respect of the Asset Purchase Agreement and the Sale Transaction are hereby approved. All objections, if any, to the Sale Motion or the relief requested therein that have not been withdrawn, waived, or settled as announced to the Court at the Sale Hearing or by stipulation filed with the Court, and all reservation of rights included therein, are hereby overruled, except as expressly provided in the final order approving the Sale Transaction entered on November 24, **[*336]** 2010 (the "Sale Order"). [32]

32 Order Authorizing (A) the Sale of Substantially All of the Assets of the Debtors Free and Clear of All Claims, Liens, Liabilities, Rights, Interests and Encumbrances; (B) the Debtors to Enter Into and Perform Their Obligations Under the Asset Purchase Agreement; (C) the Debtors to Assume and Assign Certain Executory Contracts and Unexpired Leases; (D) Approving the Transition Services Agreement; **[**89]** and (E) Granting Related Relief (Docket No. 494).

Consistent with and pursuant to the Court's bench ruling on November 24, 2010, this opinion shall supersede such bench ruling, the text of which was filed as an exhibit to the Sale Order; as indicated on the record on November 24, 2010, the filing of this opinion today shall not affect the time period for filing a notice of appeal pursuant to Federal Rule of Bankruptcy Procedure 8002 or the stay imposed by Federal Rules of Bankruptcy Procedure 6004(h) and 6006(d), which began to run on November 24, 2010. [33]

33 The Court is aware that two notices of appeal and certain related motions were filed between November 30, 2010 and December 2, 2010. The

Court has not reviewed any of these pleadings prior to issuing this opinion.

Dated: New York, New York

December 3, 2010

/s/ Shelley C. Chapman

United States Bankruptcy Judge

# TAB 7

**Peter Dalton, as Parent and Natural Guardian of Brian M. Dalton, an Infant, Respondent, v. Educational Testing Service, Appellant.**

**No. 263**

**COURT OF APPEALS OF NEW YORK**

**87 N.Y.2d 384; 663 N.E.2d 289; 639 N.Y.S.2d 977; 1995 N.Y. LEXIS 4450**

**October 19, 1995, Argued**
**December 7, 1995, Decided**

**PRIOR HISTORY:** Appeal, by permission of the Court of Appeals, from an order of the Appellate Division of the Supreme Court in the Second Judicial Department, entered July 11, 1994, which affirmed so much of a judgment of the Supreme Court (William D. Friedmann, J.; opn 155 Misc 2d 214), entered in Queens County after a nonjury trial, as directed defendant to release, without comment or qualification, Brian M. Dalton's test scores on the November 2, 1991, Scholastic Aptitude Test.

*Dalton v Educational Testing Serv.*, 206 AD2d 402, 614 N.Y.S.2d 742, modified.

**DISPOSITION:** Order modified in accordance with the opinion herein and, as so modified, affirmed, without costs.

**COUNSEL:** *White & Case*, New York City (*Philip H. Schaeffer*, *J. Stepan Wood* and *William R. Spiegelberger* of counsel), and *Wilmer, Cutler & Pickering* (*Bruce Berman* and *Michael F. Bennet*, of the District of Columbia Bar, admitted *pro hac vice*, of counsel), for appellant. I. Educational Testing Service (ETS) did not breach the duty of good faith and fair dealing. (*Rowe v Great Atl. & Pac. Tea Co.,* 46 NY2d 62, 412 N.Y.S.2d 827, 385 N.E.2d 566; *Van Valkenburgh, Nooger & Neville v Hayden Publ. Co.,* 30 N.Y.2d 34, 409 U.S. 875; *Gordon v Nationwide Mut. Ins. Co.,* 30 N.Y.2d 427, 410 U.S. 931; *Kirke La Shelle Co. v Armstrong Co.,* 263 NY 79, 188 N.E. 163; *Murphy v American Home Prods. Corp.,* 58 NY2d 293, 461 N.Y.S.2d 232, 448 N.E.2d 86; *Wieder v Skala,* 80 NY2d 628, 593 N.Y.S.2d 752, 609 N.E.2d 105; *Bank of China v Chan,* 937 F2d 780; *Havel v Kelsey-Hayes Co.,* 83 AD2d 380, 445 N.Y.S.2d 333; *M/A-Com Sec. Corp. v Galesi,* 904 F2d 134; *Tuttle v Grant Co.,* 5 A.D.2d 370, 6 N.Y.2d 754.) II. Notwithstanding their de novo review of the evidence, the lower courts did not find that Dalton's scores are valid. III. If ETS' review was inadequate, the matter should have been remanded to ETS for further consideration. (*Matter of Olsson v Board of Higher Educ.,* 49 NY2d 408, 426 N.Y.S.2d 248, 402 N.E.2d 1150; *Matter of Chusid v Albany Med. Coll.,* 157 A.D.2d 1019, 75 N.Y.2d 711; *Matter of Susan M. v New York Law School,* 149 A.D.2d 69, 76 N.Y.2d 241; *Matter of Yaeger v Educational Testing Serv.,* 158 AD2d 602, 551 N.Y.S.2d 574; *De Pina v Educational Testing Serv.,* 31 AD2d 744, 297 N.Y.S.2d 472; *Matter of K. D. v Educational Testing Serv.,* 87 Misc 2d 657, 386 N.Y.S.2d 747.)

*Nicolosi & Sciacca*, Bayside (*Vincent F. Nicolosi* and *Laurie S. Hershey* of counsel), for respondent. I. The lower courts only held ETS to its express and implied commitments and did not expand the implied covenant of good faith as reasonably understood by the parties. (*Wood v Lucy, Lady Duff-Gordon,* 222 NY 88, 118 N.E. 214; *Rowe v Great Atl. & Pac. Tea Co.,* 46 NY2d 62, 412 N.Y.S.2d 827, 385 N.E.2d 566; *Kirke La Shelle Co. v*

*Armstrong Co.,* 263 NY 79, 188 N.E. 163; *Wieder v Skala,* 80 NY2d 628, 593 N.Y.S.2d 752, 609 N.E.2d 105; *De Pina v Educational Testing Serv.,* 31 AD2d 744, 297 N.Y.S.2d 472; *Matter of K. D. v Educational Testing Serv.,* 87 Misc 2d 657, 386 N.Y.S.2d 747; *Johnson v Educational Testing Serv.,* 615 F Supp 633, 754 F2d 20, 472 US 1029; *Matter of Seagroatt Floral Co. [Riccardi],* 78 NY2d 439; *Humphrey v State of New York,* 60 NY2d 742, 469 N.Y.S.2d 661, 457 N.E.2d 767; *Najjar Indus. v City of New York [Mersereau Pumping Sta.],* 57 NY2d 647, 454 N.Y.S.2d 65, 439 N.E.2d 874.) II. The trial court acted correctly in ordering ETS to release the scores without comment or qualification. (*Matter of Olsson v Board of Higher Educ.,* 49 NY2d 408, 426 N.Y.S.2d 248, 402 N.E.2d 1150; *Matter of Susan M. v New York Law School,* 149 A.D.2d 69, 76 N.Y.2d 241; *Lowinger v Touro Coll.,* 202 AD2d 298, 610 N.Y.S.2d 771; *Morales v New York Univ.,* 83 A.D.2d 811, 55 N.Y.2d 822; *Melvin v Union Coll.,* 195 AD2d 447, 600 N.Y.S.2d 141; *Tedeschi v Wagner Coll.,* 49 NY2d 652, 427 N.Y.S.2d 760, 404 N.E.2d 1302; *Muller v Muller,* 266 NY 68, 193 N.E. 642; *Demilo Corp. v E.K. Constr. Co.,* 207 AD2d 480, 616 N.Y.S.2d 240; *Van Wagner Adv. Corp. v S & M Enters.,* 67 NY2d 186, 501 N.Y.S.2d 628, 492 N.E.2d 756; *Matter of Hall v Johnstone,* 209 AD2d 982, 620 N.Y.S.2d 630.)

**JUDGES:** Judges Titone, Bellacosa, Smith and Ciparick concur with Chief Judge Kaye; Judge Levine dissents and votes to reverse in a separate opinion in which Judge Simons concurs.

**OPINION BY:** KAYE

**OPINION**

**[*386] [**290] [***978]** Chief Judge Kaye.

**[1, 2]** The primary question before us is whether defendant, Educational Testing Service (ETS), a standardized testing firm, complied with procedures specified in its contract with high school senior Brian Dalton in refusing to release Dalton's Scholastic Aptitude Test (SAT) score. Because the factual findings underlying the trial court's determination that ETS failed to act in good faith in following those procedures were affirmed by the Appellate Division, have support in the record and are consequently beyond the scope of our review, we conclude--as did the trial court and Appellate Division--that ETS breached its contract with Dalton. Though we agree, moreover, with the **[*387]** courts below that specific performance is the appropriate remedy, we nevertheless conclude that the promised performance was good-faith compliance with the stated procedures, not release of the questioned scores as ordered by those courts.

I

In May 1991, Brian Dalton took the SAT, which was administered by ETS, at Holy Cross High School in Queens where Dalton was a junior. Six months later, in November, he took the examination a second time, as a senior, this time at John Bowne High School in Queens, and his combined score increased 410 points.

Because Dalton's score increased by more than 350 points, his test results fell within the ETS category of "Large Score Differences" or "discrepant scores." In accordance with ETS policy, members of the ETS Test Security Office therefore reviewed his May and November answer sheets. Upon a finding of disparate handwriting, the answer sheets were submitted to a document examiner, who opined that they were completed by separate individuals. Dalton's case was then forwarded to the Board of Review, which preliminarily decided that substantial evidence supported cancelling Dalton's November score.

Upon registering for the November SAT, Dalton had signed a statement agreeing to the conditions in the New York State edition of the Registration Bulletin, which reserved to ETS "the right to cancel any test score ... if ETS believes that there is reason to question the score's validity." The Registration Bulletin further provided that, if "the validity of a test score is questioned because it may have been obtained unfairly, ETS [will] notif[y] the test taker of the reasons for questioning the score" and offer the test-taker the following five options: (1) the opportunity to provide additional information, (2) confirmation of the score by taking a free retest, (3) authorization for ETS to cancel the score and refund all fees, (4) third-party review by any institution receiving the test score or (5) arbitration.

As specified in the Registration Bulletin, ETS apprised Dalton of its preliminary decision to cancel his November SAT score in a letter from Test Security Specialist Celeste M. Eppinger. Noting the handwriting disparity and the substantial difference between his May and November test results, Eppinger informed Dalton that

"[t]he evidence suggests that **[*388]** someone else may have completed your answer sheet and that the questioned scores may be invalid." She advised him that he could supply "any additional information that will help explain" this or, alternatively, elect one of the other options.

Eppinger enclosed the Procedures for Questioned Scores pamphlet with her letter, which reiterated the test-taker's right to "submit additional relevant information" to the Board of Review supporting the validity of questioned scores. In cautioning test-takers to provide only information "relevant to the questions being raised," the Procedures for Questioned Scores explained, "[f]or example, character references or testimonial letters do not explain handwriting differences." As to the four additional options, the guide further explained, "ETS also offers other options ... if additional information **[**291]** **[***979]** doesn't resolve the questions about the validity of the scores. The option to provide additional information to resolve these questions may be used in combination with one or more of the[se] options."

Dalton opted to present additional information to the Board of Review, including the following: verification that he was suffering from mononucleosis during the May examination; diagnostic test results from a preparatory course he took prior to the November examination (he had taken no similar course prior to the May SAT) that were consistent with his performance on that test; a statement from an ETS proctor who remembered Dalton's presence during the November examination; and statements from two students--one previously unacquainted with Dalton--that he had been in the classroom during that test. Dalton further provided ETS with a report from a document examiner obtained by his family who concluded that Dalton was the author of both sets of answer sheets.

ETS, after several Board of Review meetings, submitted the various handwriting exemplars to a second document examiner who, like its first, opined that the May and November tests were not completed by the same individual. As a result, ETS continued to question the validity of Dalton's November score.

At this point plaintiff Peter Dalton, father and natural guardian of Brian Dalton, filed a CPLR article 78 proceeding, later converted to an action at law, to prohibit ETS from cancelling Dalton's November SAT score and to compel immediate release of the score. Following a 12-day nonjury trial, the trial court found that ETS failed "to make even rudimentary efforts to evaluate or investigate the information" furnished by **[*389]** Dalton and thus concluded that ETS failed to act in good faith in determining the legitimacy of Dalton's score, thereby breaching its contract (155 Misc. 2d 214, 225). The trial court premised this conclusion on its determination that the ETS Board of Review members failed to evaluate the information submitted because they believed Dalton's presence at the November SAT to be wholly irrelevant to the handwriting issue and that he could controvert the Board's preliminary finding that the score was invalid solely by taking a retest. As a remedy for the contractual breach, the trial court ordered ETS to release the November SAT score.

The Appellate Division affirmed. It too found that ETS ignored the documentation provided by Dalton and considered only the reports of its own document examiners. Like the trial court, the Appellate Division concluded that this failure to evaluate as well as to investigate Dalton's information constituted a breach of contract. In light of these factual determinations, we agree that ETS breached its contract with Dalton but differ as to the scope of the relief.

II

By accepting ETS' standardized form agreement when he registered for the November SAT, Dalton entered into a contract with ETS (*see*, *AEB & Assocs. Design Group v Tonka Corp.,* 853 F. Supp. 724, 732). Implicit in all contracts is a covenant of good faith and fair dealing in the course of contract performance (*see*, *Van Valkenburgh, Nooger & Neville v Hayden Publ. Co.,* 30 N.Y.2d 34, 45, 330 N.Y.S.2d 329, 281 N.E.2d 142, *cert denied* 409 U.S. 875, 34 L. Ed. 2d 128, 93 S. Ct. 125).

Encompassed within the implied obligation of each promisor to exercise good faith are " 'any promises which a reasonable person in the position of the promisee would be justified in understanding were included' " (*Rowe v Great Atl. & Pac. Tea Co.,* 46 N.Y.2d 62, 69, 412 N.Y.S.2d 827, 385 N.E.2d 566, quoting 5 Williston, Contracts § 1293, at 3682 [rev ed 1937]). This embraces a pledge that "neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract" (*Kirke La Shelle Co. v Armstrong Co.,* 263 N.Y. 79, 87, 188 N.E. 163). Where the contract contemplates the exercise of

discretion, this pledge includes a promise not to act arbitrarily or irrationally in exercising that discretion (*see*, *Tedeschi v Wagner Coll.,* 49 N.Y.2d 652, 659, 427 N.Y.S.2d 760, 404 N.E.2d 1302). The duty of **[**292]** **[***980]** good faith and fair dealing, however, is not without limits, and no obligation can be implied that "would be inconsistent with other terms of the contractual relationship" (*Murphy v American Home Prods. Corp.,* 58 N.Y.2d 293, 304, 461 N.Y.S.2d 232, 448 N.E.2d 86).

**[*390]** The parties here agreed to the provisions in the Registration Bulletin, which expressly permit cancellation of a test score so long as ETS found "reason to question" its validity after offering the test-taker the five specified options. Nothing in the contract compelled ETS to prove that the test-taker cheated. Nor did the invitation to the test-taker to furnish ETS with relevant information reasonably and realistically translate into any requirement that ETS conduct a field investigation or gather evidence to verify or counter the test-taker's documentation. Indeed, such an obligation would be inconsistent with the contractual language placing the burden squarely on the test-taker to overcome the ETS finding of score invalidity. ETS, therefore, was under no duty, express or implied, to initiate an external investigation into a questioned score.

The contract, however, did require that ETS consider any relevant material that Dalton supplied to the Board of Review. The Registration Bulletin explicitly afforded Dalton the option to provide ETS with relevant information upon notification that ETS questioned the legitimacy of his test score. Having elected to offer this option, it was certainly reasonable to expect that ETS would, at the very least, consider any relevant material submitted in reaching its final decision.

Dalton triggered this implied-in-law obligation on the part of ETS by exercising his contractual option to provide ETS with information (*compare*, *Matter of Yaeger v Educational Testing Serv.,* 158 A.D.2d 602, 551 N.Y.S.2d 574 [where test-taker declined to invoke any of the proffered options, ETS cancelled score in good faith and in accordance with terms of the contract]). Significantly, Dalton heeded the advice in the Procedures for Questioned Scores and tendered numerous documents that did more than simply deny allegations of wrongdoing or attest to his good character, such as medical evidence regarding his physical condition, statements by fellow test-takers, the statement of a classroom proctor and consistent diagnostic test results (*compare, Swencki v Educational Testing Serv.,* No. C 81-0689 [WD KY] [test-taker sent letter to ETS explaining that he could not have cheated]; *Matter of K. D. v Educational Testing Serv.,* 87 Misc. 2d 657, 386 N.Y.S.2d 747 [test-taker submitted sworn statement that he did not cheat]).

Nevertheless, with the exception of the document examiner's report, ETS disputes the relevancy of this information. Specifically, ETS maintains that the sole issue before the Board of Review was the disparate handwriting and that evidence regarding Dalton's health (apart from a damaged arm) or presence during both examinations is irrelevant to resolving that issue.

**[*391]** To be sure, the Procedures for Questioned Scores warned Dalton "to provide only additional information that is relevant to the questions being raised." The Eppinger letter to Dalton, however, informed him that his November score was possibly invalid precisely because ETS believed "that someone else may have completed [his] answer sheet." Thus, ETS expressly framed the dispositive question as one of suspected impersonation. Because the statements from the classroom proctor and November test-takers corroborated Dalton's contention that he was present at and in fact took the November examination, they were relevant to this issue.

Likewise, inasmuch as the medical documentation concerning Dalton's health at the time of the May SAT provided an explanation for his poor performance on that examination, and the consistent diagnostic test results demonstrated his ability to achieve such a dramatic score increase, these items were also germane to the question whether it was Dalton or an imposter who completed the November examination. Indeed, in its manual, Policies and Procedures Concerning Scores of Questionable Validity--which details internal ETS procedure regarding questioned scores--ETS offers several examples of "relevant information" that a test-taker might provide, including "a doctor's report that the candidate was under the influence of medication at the time the low score was earned." Regarding "a case of **[**293]** **[***981]** possible impersonation" in particular, the manual suggests that "other test results might demonstrate that the questioned score is not inconsistent with other measures of the candidate's abilities." Thus, Dalton's material fell within ETS' own definition of relevancy, as

expressed in its manual and letter to Dalton.

**[1]** The critical question then is whether the Board of Review made any effort to consider this relevant information submitted by Dalton. That is a factual inquiry. Both the trial court and the Appellate Division concluded that the Board utterly failed to evaluate the material. Given these affirmed findings, "our scope of review is narrow. This Court is without power to review findings of fact if such findings are supported by evidence in the record" (*Humphrey v State of New York,* 60 N.Y.2d 742, 743, 469 N.Y.S.2d 661, 457 N.E.2d 767).

Several Board of Review members--each member alone had the power to order release of Dalton's November score--testified that they believed information establishing Dalton's presence during the November examination to be irrelevant to **[*392]** their determination* and, moreover, that only a successful retest would validate Dalton's score. Thus, there is support in the record for the factual determinations of the trial court and Appellate Division and they are binding on us. This is so notwithstanding inconsistent testimony by Board members that the Board did review Dalton's information but found it unpersuasive. In light of the affirmed findings, the Court of Appeals simply does not have authority to weigh conflicting evidence and make its own factual determinations, as the dissent would do.

> * For example, when Shirley Kane-Orr--chairperson of the Board of Review and a member of the three-member panel of the Board that initially reviewed Dalton's case on December 11, 1991, the panel that again considered his case on January 3d, 1992, and the final panel to review Dalton's case on February 7, 1992--was asked whether she "or any member of the panel or the test security office ever question[ed] [Dalton's] presence in the classroom," she answered, "[n]o"; when further asked by Dalton's counsel, "[s]o am I to assume ... that since you didn't question his presence in the classroom, that it was not an issue in this case," she responded, "[i]t was a non-issue in the sense that [it] was not an issue at all to be considered whether or not he was in the classroom." Likewise, Sydell Carlton, member of the panel that considered Dalton's case on January 17, 1992, was also asked whether she ever questioned Dalton's presence in the classroom, to which she replied, "[t]hat was not an issue for us to decide. The issue for us to decide was, why are those handwritings disparate? His presence in the room was not, for us, in issue."

Consequently, this case is factually distinct from those relied upon by ETS, where the testing service considered but then rejected information provided by the test-taker (*see, e.g.*, *Langston v ACT,* 890 F.2d 380; *Denburg v Educational Testing Serv.,* No. C-1715-83 [NJ Super Ct]; *cf.*, *Johnson v Educational Testing Serv.,* 754 F.2d 20, 26, *cert denied* 472 U.S. 1029, 87 L. Ed. 2d 635, 105 S. Ct. 3504 [noting that ETS provided test-taker with opportunity to be heard and to be represented by counsel]). When ETS fulfills its contractual obligation to consider relevant material provided by the test-taker and otherwise acts in good faith, the testing service--not the courts--must be the final arbiter of both the appropriate weight to accord that material and the validity of the test score. This Court will not interfere with that discretionary determination unless it is performed arbitrarily or irrationally.

Where, however, ETS refuses to exercise its discretion in the first instance by declining even to consider relevant material submitted by the test-taker, the legal question is whether this refusal breached an express or implied term of the contract, not whether it was arbitrary or irrational. Here, the courts below agreed that ETS did not consider the relevant information **[*393]** furnished by Dalton. By doing so, ETS failed to comply in good faith with its own test security procedures, thereby breaching its contract with Dalton.

The dissent urges that because the trial court and Appellate Division relied in part on ETS' failure to investigate Dalton's information, they arguably employed an erroneous legal standard. Overlooked, however, is that both courts also concluded that ETS' refusal to evaluate the material breached the contract with Dalton and, thus, employed a correct legal standard. Moreover, the crucial **[**294]** **[***982]** factual inquiry under the correct standard--whether ETS considered Dalton's relevant material--has already been resolved by those courts. Because this factual finding dictates the legal conclusion that ETS breached the contract, remittal is unnecessary.

III

**[2]** We agree with the trial court and Appellate Division that Dalton is entitled to specific performance of

the contract. Dalton is not, however, entitled to release of his score as though fully validated. The goal of specific performance is to produce "as nearly as is practicable, the same effect as if the contract had been performed" (Farnsworth, Contracts § 12.5, at 823 [1982]). Had the contract here been performed, ETS would have considered the information provided by Dalton in reaching a final decision. ETS never promised to release a score believed to be invalid, and the validity of Dalton's November SAT score has yet to be determined. Indeed, the trial court specifically noted that it was not resolving the question whether Dalton in fact took the November test.

In an analogous context, we have refused to compel a university to issue a degree to a student who had not fulfilled the academic requirements (*see*, *Matter of Olsson v Board of Higher Educ.,* 49 N.Y.2d 408, 426 N.Y.S.2d 248, 402 N.E.2d 1150). This reluctance to interfere with the exercise of academic discretion is motivated by sound considerations of public policy. "When an educational institution issues a diploma to one of its students, it is, in effect, certifying to society that the student possesses all of the knowledge and skills that are required by his [or her] chosen discipline" (*id.,* at 413). Likewise, we have held that a college did not act arbitrarily in declining to "round off" a student's failing grade so that she could graduate (*see*, *Matter of McIntosh v Borough of Manhattan Community Coll.,* 78 A.D.2d 839, 433 N.Y.S.2d 446, *affd* 55 N.Y.2d 913, 449 N.Y.S.2d 26, 433 N.E.2d 1274).

The comparison between ETS and academic institutions is surely not exact, inasmuch as judicial restraint in matters of **[*394]** academic achievement is based, in part, on the inherently subjective nature of the evaluation to be made by professional educators (*see*, *Tedeschi v Wagner Coll.,* 49 N.Y.2d 652, 658, 427 N.Y.S.2d 760, 404 N.E.2d 1302, *supra*). Still, similar policy concerns militate against directing ETS to release a questioned score. When a standardized testing service reports a score, it certifies to the world that the test-taker possesses the requisite knowledge and skills to achieve the particular score. Like academic credentials, if courts were to require testing services to release questioned scores, "the value of these credentials from the point of view of society would be seriously undermined" (*Olsson, supra,* at 413). Given the reliance that students, educational institutions, prospective employers and others place on the legitimacy of scores released by ETS, requiring challenged scores to be reported would be contrary to the public interest and exceed the scope of ETS' promised performance.

While courts as a matter of policy are reluctant to intrude upon academic discretion in educational matters, they stand ready as a matter of law and equity to enforce contract rights. Where a contract is breached, moreover, and the injured party is entitled to specific performance, the remedy must be a real one, not an exercise in futility.

Dalton is entitled to relief that comports with ETS' contractual promise--good-faith consideration of the material he submitted to ETS. We cannot agree with Dalton's assumption that ETS will merely rubber-stamp its prior determination without good-faith attention to his documentation and that reconsideration by ETS will be an empty exercise. Our conclusion that the contract affords Dalton a meaningful remedy rests also on the provision in the Procedures for Questioned Scores allowing Dalton to utilize one or more of the remaining four options in combination with renewed consideration by the Board of Review. Those options--including third-party review by any institution receiving the test score as well as arbitration--remain available should ETS determine that the information submitted fails to resolve its concerns about the validity of the November score.

Accordingly, the Appellate Division order should be modified in accordance with this **[**295]** **[***983]** opinion and, as so modified, affirmed, without costs.

**DISSENT BY:** LEVINE

**DISSENT**

Levine, J. (Dissenting). I agree with the majority that the Educational Testing Service (ETS) had no duty, express or implied, to investigate the information submitted by Brian **[*395]** Dalton. However, I do not agree that we are bound by the factual determinations of the lower courts, which are based on an erroneous legal standard, or that the record contains any evidence that ETS arbitrarily failed to consider the materials submitted by Dalton. I, therefore, respectfully dissent.

A primary obligation of ETS as administrator of the SAT and other scholastic aptitude tests heavily relied upon by institutions of higher education is to certify that released scores accurately reflect the performance on the test of the identified test taker. The college admission

process is highly dependent on the authenticity of the SAT scores released by ETS, as are other test takers whose scores are valued in relation to those of all others who take the exam and are competing for admission. In order to ensure the reliability of its certification process, ETS has established elaborate procedures that balance the harms to institutions and other candidates of the release of possibly invalid scores against the detriment to students whose scores are challenged as potentially invalid. The procedures established by ETS are unquestionably fair; they give test takers whose scores are questioned opportunity after opportunity to validate their scores. In the end, however, ETS as a practical necessity must be the final arbiter of whether it can honestly certify the validity of a student's score. Thus, the standard contract between ETS and test takers reserves to ETS the right "to cancel any test score ... if ETS believes that *there is reason to question* the score's validity [emphasis supplied]."

Peter Dalton, Brian Dalton's father, brought this suit based on the claim that ETS treated Brian Dalton unfairly because it did not conduct a thorough investigation of the material Brian submitted to ETS when his scores were questioned. The trial court accepted Dalton's argument. * Thus, to support its conclusion that ETS failed "to make even rudimentary efforts to evaluate or investigate the information furnished by" Dalton and thus failed to act in good faith in carrying out its obligations to Dalton, the court pointed to ETS's failure to make contact with or question the proctor, the test administrator, or other students who gave evidence that tended to show that Dalton was present, and to ETS's refusal to conduct fingerprint **[*396]** or lie detector tests on Dalton (155 Misc. 2d 214, 225). Likewise, the Appellate Division clearly considered ETS's failure to investigate as a factor in its ultimate conclusion that ETS acted without good faith: "The practice of ignoring Dalton's evidence *without even initiating a preliminary investigation* clearly demonstrate a lack of good faith by ETS" (206 A.D.2d 402, 403 [emphasis supplied]).

* Notably, Dalton's scores had not been finally cancelled at the inception of this suit. Dalton had been offered, but refused, the opportunity to validate his scores by taking another test at the expense of ETS and scoring within a specified range of his November score, or to submit the matter to arbitration.

My colleagues in the majority here, however, correctly conclude that ETS had no express or implied duty to investigate. Thus, it seems indisputable that the ultimate determinations of the courts below--that ETS breached its implied covenant of good faith and fair dealing--were reached at least in significant part by reliance on an erroneous legal standard, that ETS had a duty to investigate. Thus, at a minimum, reversal and remittal for new findings based on the proper legal standard is required here.

However, applying the correct legal standard to the record evidence, it is my conclusion that ETS fulfilled its contractual obligations as a matter of law and, therefore, we should reverse and dismiss the Daltons' complaint.

As the Chief Judge concludes, ETS was contractually obligated to consider any relevant material that Dalton supplied the Board of Review (majority opn, at 390). After considering **[**296]** **[***984]** that evidence, ETS had the stated right to cancel Dalton's test score if it possessed "a reason to question" the score's validity. Thus, it seems self-evident that ETS expressly reserved to itself substantial discretion on whether to refuse to certify a test score.

To be sure, there is a covenant of good faith and fair dealing implicit in the contract between Dalton and ETS (*see*, *Rowe v Great Atl. & Pac. Tea Co.,* 46 N.Y.2d 62, 68, 412 N.Y.S.2d 827, 385 N.E.2d 566; *Van Valkenburgh, Nooger & Neville v Hayden Publ. Co.,* 30 N.Y.2d 34, 45, 330 N.Y.S.2d 329, 281 N.E.2d 142, *cert denied* 409 U.S. 875, 34 L. Ed. 2d 128, 93 S. Ct. 125). It requires that "neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract" (*Kirke La Shelle Co. v Armstrong Co.,* 263 N.Y. 79, 87, 188 N.E. 163). In this way, the implied covenant "is in aid and furtherance of other terms of the agreement of the parties. No obligation can be implied, however, which would be inconsistent with other terms of the contractual relationship" (*Murphy v American Home Prods. Corp.,* 58 N.Y.2d 293, 304, 461 N.Y.S.2d 232, 448 N.E.2d 86 [rejecting application of implied covenant to at-will employment contracts]). Where good faith is an *express* condition of a contract that contemplates a wide scope of discretion on the part of one party, there **[*397]** is no breach if the discretionary act performed is "not arbitrary and capricious" (*Smith v Robson,* 148 N.Y. 252, 255, 42 N.E. 677; *see also*, 3A Corbin, Contracts § 647, at

104-106). The implied covenant does no more; it works only to ensure that a party with whom discretion is vested does not act arbitrarily or irrationally (*see, e.g.*, *Tedeschi v Wagner Coll.,* 49 N.Y.2d 652, 659, 427 N.Y.S.2d 760, 404 N.E.2d 1302).

Thus, the issue here is whether there is evidence that ETS performed its discretionary functions arbitrarily or irrationally, or with bad faith in fact (*cf.*, *Langston v ACT,* 890 F.2d 380, 386; *Johnson v Educational Testing Serv.,* 754 F.2d 20, *cert denied* 472 U.S. 1029, 87 L. Ed. 2d 635, 105 S. Ct. 3504 [American College Testing Program only contractually required to act in good faith]).

Here, there was no evidence of bad faith in fact. Moreover, ETS had two definitive reports of highly qualified handwriting experts, of proven reliability, that the November 1991 answer sheet was filled out by someone other than the person who filled out the May 1991 exam answer sheet and the documents known to have been signed or produced by Brian Dalton. Surely it was not irrational or arbitrary for ETS to find that the unexplained disparate handwriting on the November 1991 answer sheet gave it reason to question the validity of the second test score. The courts below did not find otherwise. Nor can it be said that, as a matter of law, the evidence submitted by Dalton totally obviated the reasons ETS had to question the test score. It was, therefore, not a breach of the implied covenant of good faith to refuse to certify Dalton's scores after consideration of the evidence submitted, and the majority does not so hold.

Rather the majority holds that there is evidence that ETS breached its implied covenant of good faith in its deliberative process in failing "to consider" Dalton's submissions (majority opn, at 391). However, the uncontroverted evidence accepted by the courts below and the majority here is that when ETS received the information submitted by Dalton it did not totally disregard it. Rather, it considered it and judged it weighty enough to merit further evaluation. Thus, it is undeniable that ETS responded to the submissions by retaining another handwriting expert to get a third evaluation of the documents. In addition, ETS submitted Dalton's additional handwriting samples to its first handwriting expert for a second evaluation.

To overcome this concrete evidence of consideration, the majority points to selectively narrow portions of the record in which ETS Board of Review members testified that they deemed irrelevant Dalton's evidence that tended to show he **[*398]** was in the room on the day the test was given as evidence that ETS "failed to consider" Dalton's submissions, which in turn supported the determination of its breach of the implied covenant of good faith and fair dealing. I disagree.

**[**297]** **[***985]** Again, it is uncontroverted that each member of the ETS Board of Review gave a *reason* why he or she found Dalton's submissions irrelevant. Therefore, a breach of the implied covenant of good faith and fair dealing could only be established if the *reason* the Board members gave to deem irrelevant Dalton's submissions was arbitrary, capricious or irrational. Each Board member testified that the evidence did not explain their one lingering crucial doubt, the disparate handwriting, which was the exact doubt communicated to Dalton by ETS--"someone else may have completed [the] answer sheet" (Dec. 11, 1991 letter to Brian Dalton). Because the reason to deem irrelevant Dalton's evidence of presence was not irrational, arbitrary or capricious it cannot, as a matter of law, form the basis of a breach of the implied covenant of good faith. It is only by substituting its judgment for that of ETS as to what should have been deemed relevant evidence that the majority finds evidence of bad faith. However, "[w]hen an [institutional decision maker] ... acts within its jurisdiction, not arbitrarily but in the exercise of an honest discretion based on facts within its knowledge that justify the exercise of discretion, a court may not review the exercise of its discretion" (*Matter of Carr v St. John's Univ.,* 17 A.D.2d 632, 634, 231 N.Y.S.2d 410, *affd* 12 N.Y.2d 802, 235 N.Y.S.2d 834, 187 N.E.2d 18; *see also*, *Matter of Harris v Trustees of Columbia Univ.,* 98 A.D.2d 58, 70, 470 N.Y.S.2d 368 [Kassal, J., dissenting], *revd on dissenting opn below* 62 N.Y.2d 956).

In sum, ETS acted within its discretion in continuing the security process rather than releasing the score after considering and rejecting Dalton's evidence. There is no evidence that ETS acted arbitrarily in its discretionary decision-making process. Hence there is no evidence that ETS breached any express or implied covenant in its contract with Dalton. Accordingly, I would reverse the order of the Appellate Division and dismiss the complaint.

Judges Titone, Bellacosa, Smith and Ciparick concur with Chief Judge Kaye; Judge Levine dissents and votes to reverse in a separate opinion in which Judge Simons concurs.

Order modified in accordance with the opinion herein and, as so modified, affirmed, without costs.

# TAB 8

Restatement of the Law, Second, Contracts
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Case Citations

Rules and Principles

Chapter 9 - The Scope of Contractual Obligations

Topic 2 - Considerations of Fairness and the Public Interest

Restat 2d of Contracts, § 205

§ 205 Duty of Good Faith and Fair Dealing

**Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.**

**COMMENTS & ILLUSTRATIONS: Comment:**

*a. Meanings of "good faith."* Good faith is defined in Uniform Commercial Code § 1-201(19) as "honesty in fact in the conduct or transaction concerned." "In the case of a merchant" Uniform Commercial Code § 2-103(1)(b) provides that good faith means "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade." The phrase "good faith" is used in a variety of contexts, and its meaning varies somewhat with the context. Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving "bad faith" because they violate community standards of decency, fairness or reasonableness. The appropriate remedy for a breach of the duty of good faith also varies with the circumstances.

*b. Good faith purchase.* In many situations a good faith purchaser of property for value can acquire better rights in the property than his transferor had. See, e.g., § 342. In this context "good faith" focuses on the honesty of the purchaser, as distinguished from his care or negligence. Particularly in the law of negotiable instruments inquiry may be limited to "good faith" under what has been called "the rule of the pure heart and the empty head." When diligence or inquiry is a condition of the purchaser's right, it is said that good faith is not enough. This focus on honesty is appropriate to cases of good faith purchase; it is less so in cases of good faith performance.

*c. Good faith in negotiation.* This Section, like Uniform Commercial Code § 1-203, does not deal with good faith in the formation of a contract. Bad faith in negotiation, although not within the scope of this Section, may be subject to sanctions. Particular forms of bad faith in bargaining are the subjects of rules as to capacity to contract, mutual assent and consideration and of rules as to invalidating causes such as fraud and duress. See, for example, §§ 90 and 208. Moreover, remedies for bad faith in the absence of agreement are found in the law of torts or restitution. For examples of a statutory duty to bargain in good faith, see, e.g., National Labor Relations Act § 8(d) and the federal Truth in Lending Act. In cases of negotiation for modification of an existing contractual relationship, the rule stated in this

Section may overlap with more specific rules requiring negotiation in good faith. See §§ 73, 89; Uniform Commercial Code § 2-209 and Comment.

*d. Good faith performance*. Subterfuges and evasions violate the obligation of good faith in performance even though the actor believes his conduct to be justified. But the obligation goes further: bad faith may be overt or may consist of inaction, and fair dealing may require more than honesty. A complete catalogue of types of bad faith is impossible, butthe following types are among those which have been recognized in judicial decisions: evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance.

**Illustrations:**

1. A, an oil dealer, borrows $ 100,000 from B, a supplier, and agrees to buy all his requirements of certain oil products from B on stated terms until the debt is repaid. Before the debt is repaid, A makes a new arrangement with C, a competitor of B. Under the new arrangement A's business is conducted by a corporation formed and owned by A and C and managed by A, and the corporation buys all its oil products from C. The new arrangement may be found to be a subterfuge or evasion and a breach of contract by A.

2. A, owner of a shopping center, leases part of it to B, giving B the exclusive right to conduct a supermarket, the rent to be a percentage of B's gross receipts. During the term of the lease A acquires adjoining land, expands the shopping center, and leases part of the adjoining land to C for a competing supermarket. Unless such action was contemplated or is otherwise justified, there is a breach of contract by A.

3. A Insurance Company insures B against legal liability for certain bodily injuries to third persons, with a limit of liability of $ 10,000 for an accident to any one person. The policy provides that A will defend any suit covered by it but may settle. C sues B on a claim covered by the policy and offers to settle for $ 9,500. A refuses to settle on the ground that the amount is excessive, and judgment is rendered against B for $ 20,000 after a trial defended by A. A then refuses to appeal, and offers to pay $ 10,000 only if B satisfies the judgment, impairing B's opportunity to negotiate for settlement. B prosecutes an appeal, reasonably expending $ 7,500, and obtains dismissal of the claim. A has failed to deal fairly and in good faith with B and is liable for B's appeal expense.

4. A and B contract that A will perform certain demolition work for B and pay B a specified sum for materials salvaged, the contract not to "become effective until" certain insurance policies "are in full force and effect." A makes a good faith effort to obtain the insurance, but financial difficulty arising from injury to an employee of A on another job prevents A from obtaining them. A's duty to perform is discharged.

5. B submits and A accepts a bid to supply approximately 4000 tons of trap rock for an airport at a unit price. The parties execute a standard form of "Invitation, Bid, and Acceptance (Short Form Contract)" supplied by A, including typed terms "to be delivered to project as required," "delivery to start immediately," "cancellation by A may be effected at any time." Good faith requires that A order and accept the rock within a reasonable time unless A has given B notice of intent to cancel.

6. A contracts to perform services for B for such compensation "as you, in your sole judgment, may decide is reasonable." After A has performed the services, B refuses to make any determination of the value of the services. A is entitled to their value as determined by a court.

7. A suffers a loss of property covered by an insurance policy issued by B, and submits to B notice and proof of loss. The notice and proof fail to comply with requirements of the policy as to form and detail. B does not point out the defects, but remains silent and evasive, telling A broadly toperfect his claim. The defects do not bar recovery on the policy.

*e. Good faith in enforcement*. The obligation of good faith and fair dealing extends to the assertion, settlement and

litigation of contract claims and defenses. See, e.g., §§ 73, 89. The obligation is violated by dishonest conduct such as conjuring up a pretended dispute, asserting an interpretation contrary to one's own understanding, or falsification of facts. It also extends to dealing which is candid but unfair, such as taking advantage of the necessitous circumstances of the other party to extort a modification of a contract for the sale of goods without legitimate commercial reason. See Uniform Commercial Code § 2-209, Comment 2. Other types of violation have been recognized in judicial decisions: harassing demands for assurances of performance, rejection of performance for unstated reasons, willful failure to mitigate damages, and abuse of a power to determine compliance or to terminate the contract. For a statutory duty of good faith in termination, see the federal Automobile Dealer's Day in Court Act, 15 U.S.C. §§ 1221-25 (1976).

**Illustrations:**

8. A contracts to sell and ship goods to B on credit. The contract provides that, if B's credit or financial responsibility becomes impaired or unsatisfactory to A, A may demand cash or security before making shipment and may cancel if the demand is not met. A may properly demand cash or security only if he honestly believes, with reason, that the prospect of payment is impaired.

9. A contracts to sell and ship goods to B. On arrival B rejects the goods on the erroneous ground that delivery was late. B is thereafter precluded from asserting other unstated grounds then known to him which A could have cured if stated seasonably.

**REPORTERS NOTES:** This Section is new. See Farnsworth, Good Faith Performance and Commercial Reasonableness under the Uniform Commercial Code, 30 U. Chi. L. Rev. 666 (1963); Summers, "Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code, 54 Va. L. Rev. 195 (1968); 3A Corbin, Contracts §§ 654A-I (Supp. 1980). As to the development of "good faith" in German law, see Dawson, The Oracles of the Law 461-502 (1968).

For an important discussion of the concept, see Fortune v. National Cash Register Co., 373 Mass. 96, 364 N.E.2d 1251 (1977), applying it to an employment contract terminable at will. In VTR, Inc. v. Goodyear Tire & Rubber Co., 303 F. Supp. 773 (S.D.N.Y. 1969), it was held that particular conduct that would have been barred by the duty of good faith could be expressly consented to in the contract. Some of the limits of the duty are discussed in Sessions, Inc. v. Morton, 491 F.2d 854 (9th Cir. 1974); see also Commercial Contractors, Inc. v. United States F. & G. Co., 524 F.2d 944 (5th Cir. 1975) (discussing good faith, custom of trade and a general contractor's lack of duty to help a subcontractor keep his work force intact when another subcontractor offers higher wages).

*Comment b*. See Gilmore, The Commercial Doctrine of Good Faith Purchase, 63 Yale L. J. 1057 (1954).

*Comment c*. See Kessler & Fine, Culpa in Contrahendo, Bargaining in Good Faith, and Freedom of Contract: A Comparative Study, 77 Harv. L. Rev. 401 (1964); Cox, The Duty to Bargain in Good Faith, 71 Harv. L. Rev. 1401 (1958); Summers, Collective Agreements and the Law of Contracts, 78 Yale L.J. 525 (1969).

*Comment d*. Illustration 1 is based on Western Oil & Fuel Co. v. Kemp, 245 F.2d 633 (8th Cir. 1957); cf. Fort Wayne Corrugated Paper Co.v. Anchor Hocking Glass Corp., 130 F.2d 471 (3d Cir. 1942); Uniform Commercial Code § 2-306(1). Illustration 2 is based on Daitch Crystal Dairies, Inc. v. Neisloss, 8 A.D.2d 965, 190 N.Y.S.2d 737 (1959), aff'd mem., 8 N.Y.2d 723, 201 N.Y.S.2d 101, 167 N.E.2d 643 (1960); Carter v. Adler, 138 Cal. App.2d 63, 291 P.2d 111 (1955); see Annots., 170 A.L.R. 1113 (1947), 38 A.L.R.2d 1113 (1954); cf. Food Fair Stores, Inc. v. Blumberg, 234 Md. 521, 200 A.2d 166 (1964) (good faith of lessee); Uniform Commercial Code § 2-306(2) (obligation to use best efforts in cases of exclusive dealing in goods); Bloor v. Falstaff Brewing Corp., 601 F.2d 609 (2d Cir. 1979) (discussion of scope of "best efforts"); Riess v. Murchison, 503 F.2d 999 (9th Cir. 1974), cert. denied, 420 U.S. 993 (1975) (buyers of land required by implied obligation of good faith to produce, save and sell water on which sellers' adjoining lands were dependant); Center Garment Co. v. United Refrig. Co., 369 Mass. 633, 341 N.E.2d 669 (1976) (franchisor required to make at least some effort to find supplies for franchisee when previous source was cut off). Compare

Sessions, Inc. v. Morton, 491 F.2d 854 (9th Cir. 1974) (no implied obligation on lessors to agree to dedicate significant portion of land to public use even though dedication might be necessary to permit lessee to develop land). Illustration 3 is based on Brassil v. Maryland Cas. Co., 210 N.Y. 235, 104 N.E. 622 (1914); see Annot., 69 A.L.R.2d 690 (1960); cf. Annot., 40 A.L.R.2d 168 (1955) (insurer's duty to settle); Keeton, Ancillary Rights of the Insured Against His Liability Insurer, 13 Vand. L. Rev. 837 (1960); Spindle v. Travelers Ins. Cos., 66 Cal. App.3d 951, 136 Cal. Rptr. 404 (1977), discussed below in connection with Comment *e*. Illustration 4 is based on Omaha Pub. Power Dist. v. Employers' Fire Ins. Co., 327 F.2d 912 (8th Cir. 1964). Illustration 5 is based on Sylvan Crest Sand & Gravel Co. v. United States, 150 F.2d 642 (2d Cir. 1945); cf. Uniform Commercial Code § 2-309(3). Illustration 6 is based on Pillois v. Billingsley, 179 F.2d 205 (2d Cir. 1950); see also In re Estate of Hollingsworth, 88 Wash.2d 322, 560 P.2d 348 (1977); cf. California Lettuce Growers, Inc. v. Union Sugar Co., 45 Cal.2d 474, 484, 289 P.2d 785, 791 (1955) (power to fix price of goods); Uniform Commercial Code § 2-305(2) (same). Illustration 7 is based on Johnson v. Scottish Union Ins. Co., 160 Tenn. 152, 22 S.W.2d 362 (1962); cf. Uniform Commercial Code § 2-311 (cooperation in sale of goods).

*Comment e*. See Kessler & Brenner, Automobile Dealer Franchises: Vertical Integration by Contract, 66 Yale L.J. 1135 (1957). Several courts have found that an express power to terminate a contract at will was modified by a duty of good faith. See, e.g., Fortune v. National Cash Register Co., 373 Mass. 96, 364 N.E.2d 1251 (1977) (salesman's employment contract); Spindle v. Travelers Ins. Cos., 66 Cal. App.3d 951, 136 Cal. Rptr. 404 (1977), 26 Drake L. Rev. 883 (1976-77) (termination of physician's malpractice insurance allegedly as part of scheme to intimidate the profession to accept higher premiums; court analogized from the insurer's duty to settle claims in good faith, see Illustration 3, supra); L'Orange v. Medical Protective Co., 394 F.2d 57 (6th Cir. 1968) (termination of dentist's malpractice insurance as retaliation because he testified against other dentist insured by same carrier); Shell Oil Co. v. Marinello, 63 N.J. 402, 307 A.2d 598 (1973), cert. denied, 415 U.S. 920 (1974) (termination of service station franchise; court reasoned both from dominant position of franchisor and from Legislature's enactment of franchising statute not applicable to particular transaction). Illustration 8 is based on James B. Berry's Sons Co. v. Monark Gasoline & Oil Co., 32 F.2d 74 (8th Cir. 1929); cf. Uniform Commercial Code §§ 1-208, 2-609. Illustration 9 is based on Fielding v. Robertson, 141 Va. 123, 126 S.E. 231 (1925); cf. § 248; Uniform Commercial Code § 2-605(1)(a).

**CROSS REFERENCES:** ALR Annotations:

Modern status as to duration of employment where contract specifies no term but fixes daily or longer compensation. 93 A.L.R.3d 659.
Construction and effect of tenure provisions of contract or statute governing employment of college or university faculty member. 66 A.L.R.3d 1018.
Who is "employee" under employee stock-option plan or contract. 57 A.L.R.3d 787.
Validity and construction of restrictive covenant not to compete ancillary to franchise agreement. 50 A.L.R.3d 746.
"Unconscionability" as ground for refusing enforcement of contract for sale of goods or agreement collateral thereto. 18 A.L.R.3d 1305.
Necessity and sufficiency of allegation, in a suit for specific performance of a contract for the sale of land, as to the adequacy of the consideration or as to the fairness of the contract. 100 A.L.R.2d 551.
Construction and effect of agreement relating to salary of partners. 66 A.L.R.2d 1023.
"Escalator" price adjustment clauses. 63 A.L.R.2d 1337.
Validity and effect of agreement controlling the vote of corporate stock. 45 A.L.R.2d 799.
Validity, construction and effect of contract, option, or provision for repurchase by vendor. 44 A.L.R.2d 342.
Contract by seller of business not to compete as affecting his lease of other property in restricted area to one who he knows will compete with purchaser. 14 A.L.R.2d 1333.

Digest System Key Numbers:

Contracts 168

**Legal Topics:**

For related research and practice materials, see the following legal topics:
Contracts LawContract InterpretationGood Faith & Fair Dealing

# TAB 9

**STEVEN E. KADER, Plaintiff-Appellant-Cross-Appellee, v. PAPER SOFTWARE, INC. and MICHAEL McCUE, Defendants-Appellees-Cross-Appellants.**

**Docket Nos. 96-7812(L), 96-7868(XAP)**

**UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT**

**111 F.3d 337; 1997 U.S. App. LEXIS 7612; 12 I.E.R. Cas. (BNA) 1329**

**February 14, 1997, Argued**
**April 18, 1997, Decided**

**PRIOR HISTORY:** **[**1]** Appeal by plaintiff from a final judgment of the United States District Court for the Northern District of New York (Cholakis, J.) dismissing his action for constructive discharge and granting summary judgment to the defendants: plaintiff's employer and boss. Plaintiff argues that: (1) he was forced to resign due to intolerable work conditions, chiefly a sexual relationship between his wife and his boss; and (2) defendants breached implied contractual duties of good faith and fair dealing. Defendants cross-appeal from the district court's dismissal of their claims for breach of contract and breach of fiduciary duty, arguing that plaintiff's departure cost defendants a profitable business opportunity and that plaintiff disclosed confidential information.

**DISPOSITION:** Affirmed.

**COUNSEL:** RICHARD S. TAFFET, Golenbock, Eiseman, Assor & Bell, New York, NY, for Plaintiff-Appellant-Cross-Appellee.

ELLIOT SILVERMAN, New York, NY (Steven J. Cohen, Gold & Wachtel, LLP, on the brief), for Defendant-Appellee-Cross-Appellant.

**JUDGES:** Before: JACOBS, CALABRESI, and LAY, * Circuit Judges.

* The Honorable Donald P. Lay, Senior Circuit Judge, United States Court of Appeals for the Eighth Circuit, sitting by designation.

**[**2]**

**OPINION BY:** JACOBS

**OPINION**

**[*338]** JACOBS, *Circuit Judge*:

This appeal arises out of an employment contract between plaintiff Steven E. Kader and Paper Software, Inc. ("Paper"). Kader argues that his employment became intolerable when he learned that his boss, defendant Michael McCue (the founder, president, and sole shareholder of Paper) was involved in a sexual relationship with Kader's wife, who was also an employee of the company. Kader appeals from a June 5, 1996 final judgment of the United States District Court for the Northern District of New York (Cholakis, *J.*) granting summary judgment in favor of Paper and McCue on Kader's claims for constructive discharge and breach of the duties of good faith and fair dealing. [1] Paper and McCue cross-appeal from the district court's dismissal (on summary judgment) of their cross-claims that Kader breached his employment contract and his fiduciary duties of loyalty and confidentiality. *See Kader v. Paper Software, Inc.*, 1996 U.S. Dist. LEXIS 21272, No. 94-CV-1602 (CGC) (Memorandum Decision and Order) (N.D.N.Y. June 4, 1996) ("Order").

1 Kader's complaint also asserted claims for intentional infliction of emotional distress (and/or prima facie tort), and for violation of various New York state business statutes. The district court granted the defendants summary judgment on those claims, *see Kader v. Paper Software, Inc.*, 1996 U.S. Dist. LEXIS 21272, No. 94-CV-1602 (CGC) (Memorandum Decision and Order), at *5 (N.D.N.Y. June 4, 1996), and Kader did not appeal that portion of the judgment.

**[**3]** We affirm.

BACKGROUND

We review *de novo* the district court's grants of summary judgment dismissing Kader's complaint and the defendants' counterclaims, "viewing the evidence in a light most favorable to . . . the non-moving parties, and drawing all reasonable inferences in [their] favor." *Aslanidis v. United States Lines, Inc.*, 7 F.3d 1067, 1072 (2d Cir. 1993).

In September 1993, McCue hired Kader to work as a computer programmer at Paper, a software development company. Kader and Paper executed a two-year employment contract setting Kader's compensation at $ 100,000 **[*339]** the first year and $ 150,000 the second. Kader's wife, Caroline Trzcinski, had already been working at Paper for several months as an administrator and marketing representative. Kader and Trzcinski, who were experiencing marital problems, separated in May 1994. That month, Trzcinski and McCue began a sexual relationship that they announced to Kader in June or July.

Throughout that summer, the three continued to work in the same small suite of offices, and Kader continued to work directly with McCue on the company's important IBM project, for which Kader had primary responsibility. Kader alleges, **[**4]** *inter alia*, that McCue and Trzcinski openly displayed their affection for each other in and around the office, that McCue told others at Paper about the affair, and that Trzcinski attempted to limit Kader's social contact (at lunches) with other Paper employees.

On August 9, 1994, Kader announced that he was following his doctor's recommendation to take a two-week medical leave of absence because "the strain from learning of the liaison" had "taken a physical toll on [him]." In response, McCue demanded that Kader return all company property in Kader's possession, and told him not to return to work or contact any of Paper's clients until the two had met to discuss Kader's job status. At a September 12, 1994 meeting, McCue imposed certain conditions on Kader's return, insisting that Kader accept working hours and reporting requirements such as: working only 9:00 a.m. to 5:00 p.m., Monday through Friday; signing in and out of the office whenever he entered or left; and providing McCue with daily progress reports and attending weekly status meetings. McCue thereafter sent several letters asking Kader to return, including an October 17, 1994 letter saying, "I have not placed any restrictions **[**5]** on your return," and restating in milder terms the time and reporting conditions. Kader never accepted McCue's invitation, and never returned from his medical leave, although he did demand and receive payment of his current and past-due salary. Kader filed the present suit against Paper and McCue in December 1994.

DISCUSSION

A. *Constructive Discharge.*

Kader maintains that Paper constructively discharged him and thereby breached its employment agreement with him under New York law. Constructive discharge occurs when an employer "deliberately makes an employee's working conditions so intolerable that the employee is forced into an involuntary resignation." *Spence v. Maryland Casualty Co.*, 995 F.2d 1147, 1156 (2d Cir. 1993) (emphasis added) (internal quotations omitted); *see also Stetson v. NYNEX Service Co.*, 995 F.2d 355, 360 (2d Cir. 1993); *Lopez v. S.B. Thomas, Inc.*, 831 F.2d 1184, 1188 (2d Cir. 1987); *Pena v. Brattleboro Retreat*, 702 F.2d 322, 325 (2d Cir. 1983). Kader's claim does not meet this standard.

Kader's predominant complaint, as the pleadings and record make abundantly clear, is that he suffered the humiliation and stress of working under **[**6]** the direct supervision of a person who was conducting a sexual relationship with Kader's wife, and in proximity to the new couple. If the open liaison between McCue and Trzcinski is viewed as one of Kader's working conditions, it may be deemed "intolerable"; it may also be deemed "intentional," as opposed to inadvertent or fortuitous. But these circumstances do not support a claim for constructive discharge: there is no evidence to support the inference that McCue's conduct was a deliberate creation of *working conditions*, intolerable or otherwise, because

the deterioration (if any) of Kader's working conditions was only the incidental effect of McCue's independent carnal objectives. As Kader conceded at oral argument, the affair was *not* commenced in order to force his resignation. Indeed, it is patent that McCue and Trzcinski did not enter into their relationship for the purpose of altering Kader's working conditions. Kader therefore cannot establish a fundamental element of his claim, that his "employer deliberately created working conditions" that led to Kader's resignation. *Spence*, 995 F.2d at 1156.

Under these circumstances, the district court held: "although it is **[**7]** certainly understandable that working in an office where the **[*340]** owner of the company has had an affair with your now ex-wife may be uncomfortable, this is not the deliberate creation of intolerable working conditions." Order at 4. We agree. Neither our cases nor New York law have examined what relationship between deliberateness and the intolerability of working conditions is required to constitute constructive discharge. But we conclude that whatever is required was not supplied here.

Kader argues that his claim rests not on the office affair alone, but on all of the deteriorating conditions of his employment, specifically: (a) office-wide knowledge of McCue's relationship with Trzcinski; (b) restriction on Kader's social contact with other employees; (c) Kader's banishment from work; (d) the time and reporting requirements established by McCue; and (e) the removal of Kader's company property. Kader alleges that these other conditions were deliberately imposed, and that the district court erred by failing to consider them in the context of McCue's relationship with Trzcinski. He argues that courts must examine the cumulative effect of all the factors comprising a complainant's working **[**8]** conditions, and that, under this analysis, the conditions that he alleges were imposed deliberately should be deemed intolerable and thus supportive of his claim for constructive discharge.

We agree that the constructive discharge standard requires consideration of working conditions as a whole rather than one by one. *See, e.g.*, *Chertkova v. Connecticut Gen. Life Ins. Co.*, 92 F.3d 81, 90 (2d Cir. 1996) ("Because a reasonable person encounters life's circumstances cumulatively and not individually, . . . [a court should not] treat the various conditions [of a plaintiff's work environment] as separate and distinct rather than additive."). But we disagree with Kader's contention that the district court misapplied that standard here. Even when "viewed as a whole," the facts in this case do *not* "permit a finder of fact to conclude that [Kader] was forced to resign." *Id.*

Preliminarily, it is incontestable that all of the conditions that Kader deems intolerable arose out of the McCue-Trzcinski affair, conduct that concededly was not intended by Kader's employer to create an intolerable work environment. *Cf. Spence*, 995 F.2d at 1156. Moreover, the undisputed **[**9]** facts render Kader's additional, specific charges untenable:

> (a)It is apparently true that some people in Paper's offices knew or guessed about the affair; Kader cites the testimony of a co-worker who spied McCue and Trzcinski embracing in a back room. But there is no evidence that McCue *told* anyone about the affair *prior* to the time that Kader filed his complaint in this case, let alone that McCue did so in order to pain Kader.
>
> (b)Kader alleges that Trzcinski tried to limit his social contact with other employees, especially at lunch. But Trzcinski was not Kader's boss, and Kader does not connect Trzcinski's efforts to any intentional conduct by their employer.
>
> (c)As to Kader's banishment from work, Kader initiated it, when he took medical "stress" leave. Under the circumstances, no intent to fire Kader can be deduced from McCue's direction that Kader stay away from Paper and refrain from contacting clients until the two of them could sit down to talk through the situation; open issues undeniably remained.
>
> (d)Kader complains about the time and reporting requirements imposed by McCue at their September 12 meeting. None of these conditions--working only 9:00 **[**10]** a.m. to 5:00 p.m., signing in and out of the office, and providing daily progress reports and attending weekly status meetings--seems onerous or humiliating. The undisputed point,

however, is that the conditions were never actually enforced by McCue, and Kader was not subject to them for a single working day. As the district court noted, "Kader never returned to work after these conditions were imposed, thus his claims as to the impact upon him are based on his somewhat visceral reaction to the suggestion." Order at 4 n.1. Moreover, McCue's October 17 letter invited Kader to return to work without "any **[*341]** restrictions on [his] return," and thus rescinded the requirements that Kader contends were onerous. [2] Kader therefore never actually experienced the "intolerable" conditions that he alleges were imposed deliberately--a root distinction between his case and those cases (cited by Kader) in which plaintiffs were forced to endure prolonged and continuous harassment or severe abuse. [3]

(e) Finally, Kader complains that McCue came to his house to remove company property; but considering Kader's lengthening absence from work and his key position on a major ongoing project (not to mention **[**11]** the bad feeling between Kader and his boss), this step was merely prudent. It cannot be inferred that McCue was recovering company papers in order to harass Kader.

2 McCue's October 17 letter to Kader states in part:

> As stated in our meeting on September 12, I need you to work at least 40 hours per week and submit written weekly status reports and schedules regarding the projects you are involved with. Remember that in order to comply with your employment contract, all vacations must be requested with 15 days notice and must be coordinated with me.

3 *See, e.g.*, *Dortz v. City of New York*, 904 F. Supp. 127, 159-60 (S.D.N.Y. 1995) (plaintiff suffered sexual harassment and retaliation by supervisor, but was still required to engage in daily dealings with him); *Payton v. Metro-North Commuter R.R. Co.*, 1995 U.S. Dist. LEXIS 16002, No. 93- CV-4840 (SAS), 1995 WL 640591, at *4 (S.D.N.Y. Oct. 31, 1995) (plaintiff suffered pattern of unwarranted discipline and harassment over period of 19 months).

In short, **[**12]** McCue's affair with Trzcinski did not constitute the deliberate creation of working conditions. Of the other conditions cited by Kader, one was self-imposed; some were created by persons other than the employer; most were not onerous to begin with, and were in any event rescinded before they were enforced; and the last was a prudent precaution for this employer in these circumstances. Kader has demonstrated that an uneasy and stressful environment existed, but he has adduced no evidence to support an inference that his employer intentionally created an intolerable workplace. [4]

4 Neither the employment contract nor New York employment law in general renders this employer's consensual sexual behavior a workplace condition for Kader. Quite distinct are cases that arise under a law that does impose on employers specific obligations with respect to workplace conditions; this opinion therefore does not bear upon the constructive discharge of a person who is subjected to workplace conditions (such as sexual harassment or racial hatred) that may not be created by an employer as a working condition but that the employer may be required by law to ameliorate.

**[**13]** Kader's showing is therefore insufficient as a matter of law:

> a claim of constructive discharge must be dismissed as a matter of law unless the evidence is sufficient to permit a rational trier of fact to infer that the employer deliberately created working conditions that were "so difficult or unpleasant that a

reasonable person in the employee's shoes would have felt compelled to resign."

*Stetson*, 995 F.2d at 361 (citations and internal quotations omitted) (holding no claim for constructive discharge where employee was dissatisfied with his compensation, assignments, and criticisms of his work, but rank and salary were never reduced). *See also Martin v. Citibank, N.A.*, 762 F.2d 212, 221 (2d Cir. 1985) (no claim where employee had unpleasant assignments and difficult relationship with supervisor but suffered no more than petty irritants); *Pena*, 702 F.2d at 324-26 (no claim where employee was dissatisfied with nature of work assignments and change in responsibilities but had experienced no loss of pay or change in title); *Spence*, 995 F.2d at 1156 ("An employer is entitled to insist on as high a standard of work performance as it deems appropriate, and **[**14]** the fact that an employee develops stress-related ill health from the demands of his voluntarily undertaken position or from criticisms of his performance, and as a result determines that health considerations mandate his resignation, does not normally amount to a constructive discharge by the employer.").

B. *Good Faith and Fair Dealing.*

The district court also properly dismissed Kader's claim that the defendants breached their duties of good faith and fair **[*342]** dealing by preventing him "not only from carrying out the terms of his employment agreement in all respects but also from receiving the compensation and other benefits provided for under the agreement." Appellant's Brief at 38. This claim has the same defects as the constructive discharge claim. The covenant of good faith and fair dealing, implied in every contract under New York law, "includes 'an implied undertaking on the part of each party that he will not intentionally and purposely do anything to prevent the other party from carrying out the agreement on his part.'" *Carvel Corp. v. Diversified Management Group, Inc.*, 930 F.2d 228, 230 (2d Cir. 1991) (quoting *Grad v. Roberts*, 14 N.Y.2d 70, 75, 248 N.Y.S.2d 633, 637, **[**15]** 198 N.E.2d 26, 28 (1964)) (emphasis added). As explained above, Kader cannot show that any of the defendants' (allegedly) *intentional* acts were sufficient to prevent him from "carrying out the terms of his employment agreement in all respects"; and the only act of the defendants that might arguably have been an impediment--the McCue-Trzcinski affair--concededly was *not* committed "intentionally and purposely" to achieve that result.

C. *Counterclaims.*

The district court dismissed both of the defendants' counterclaims, essentially for lack of admissible evidence that the defendants suffered damages by reason of Kader's departure. The counterclaims allege: (1) that Kader breached his employment contract by refusing to return to work, thus causing Paper to lose a lucrative contract with IBM (apparently Paper's second biggest project); and (2) that Kader breached his fiduciary duty to Paper by performing computer services for his father's company (on Paper's time) and by disclosing confidential information.

The fiduciary duty claim borders on the frivolous. The record does not contain sufficient facts to demonstrate that Kader "used or divulged confidential knowledge **[**16]** acquired during his employment." Kaufman v. IBM Corp., 97 A.D.2d 925, 470 N.Y.S.2d 720, 723 (3d Dep't 1983), *aff'd mem.*, 61 N.Y.2d 930, 474 N.Y.S.2d 721, 463 N.E.2d 37 (1984); *see also Q-Co Indus., Inc. v. Hoffman*, 625 F. Supp. 608, 617 (S.D.N.Y. 1985).

As to the breach of contract claim, Kader argued in the district court that the defendants failed to provide any admissible evidence to support the claim, and in particular that they had "not provided support for any of the damages asserted in these claims." Order at 3. The district court granted Kader summary judgment, rejecting the defendants' arguments that their claim was sufficiently particularized and contained sufficient allegations of damages. *Id.* Upon our *de novo* review, we agree with the district court.

The counterclaimants' theory is that the company suffered injury when Kader left Paper in the lurch on the IBM contract. The particulars offered in support are that Kader was the principal (perhaps only) employee at Paper assigned to the IBM project; that he had extensive contact with his counterparts at IBM, including frequent travel to IBM's offices; that after Kader's departure, his IBM contacts expressed concern **[**17]** to McCue over Kader's absence from the project; and that ultimately these individuals became dissatisfied with Paper's performance, causing IBM to cancel the contract and Paper to suffer monetary damages. In opposition to Kader's motion for summary judgment, McCue filed a

declaration that undertook to substantiate Paper's damages through "realistic" estimates "based on [his] direct experience."

The difficulty for the defendants is that much of what McCue says about the reasons for the loss of the IBM contract, and the damages therefrom, is inadmissible hearsay. Indeed, McCue admits that he

> attempted to obtain testimony from IBM representatives with knowledge of Kader's faulty performance and the deterioration of the relationship between [Paper] and IBM which resulted. Regrettably, the corporate culture at IBM is such that individuals are fearful of "getting involved" in the affairs of others, and, as a result, I have been unable to obtain a corroborative statement from IBM.

In these circumstances, we agree with the district court that the defendants failed to **[*343]** come forward with admissible evidence demonstrating a genuine issue for trial on the breach of contract **[**18]** claim, and thereby failed to carry their burden in opposing summary judgment. *See Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 586-87, 89 L. Ed. 2d 538, 106 S. Ct. 1348 (1986); *Rule v. Brine, Inc.*, 85 F.3d 1002, 1011 (2d Cir. 1996). McCue's declaration furnishes insufficient support for the fact that Kader's absence from the project caused the loss of IBM's business, the amount of business IBM would otherwise have done with Paper, and the profit (if any) Paper would have realized from that business. Even if Kader's absence did disrupt his employer's relationship with IBM, it is impossible to see how the defendants can attribute the loss to Kader's conduct when they conceded at oral argument that the McCue-Trzcinski affair was "emotionally unfortunate" and "emotionally awkward"; that in light of the affair it "would have been very emotionally uncomfortable for [Kader] to come to work"; and that it was "understandable at a human level why [Kader] didn't want to come to work," and "very understandable" that he would have been "very uncomfortable" doing so. Although (as held above) the employer did not precipitate these events for the purpose or with the intent of altering Kader's working **[**19]** conditions, that was admittedly the effect of what was done; and having done that, the employer cannot hold Kader accountable for the consequences of his departure.

Last, the defendants argue on appeal that they are entitled at least to recover the salary that was paid to Kader during his (ultimately permanent) medical leave from Paper. At oral argument, counsel for the defendants conceded that the evidence of damages from the loss of the IBM contract was "thin[]," but maintained that the defendants were "serious" about the claim for "the salary for the time that [Kader] didn't show up" to work. The counterclaims, however, do not contain a plea for the return of wages, and the McCue declaration neither specifies nor substantiates the amount of any such claim.

Consistent with the defendants' concession at oral argument that "we would not have sued [Kader] had he not sued us," we think it obvious that the counterclaims here were merely tactical.

**CONCLUSION**

For the reasons stated, the judgment of the district court dismissing Kader's claims and the defendants' counterclaims is affirmed in full.

# TAB 10

**FASOLINO FOODS CO., INC., Plaintiff-Appellant, -v.- BANCA NAZIONALE DEL LAVORO, Defendant-Appellee. BANCA NAZIONALE DEL LAVORO, Third-Party Plaintiff-Appellee, -v.- ANTONIO R. FASOLINO, Third-Party Defendant-Appellant.**

**Docket No. 91-7560**

**UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT**

**961 F.2d 1052; 1992 U.S. App. LEXIS 6831; 17 U.C.C. Rep. Serv. 2d (Callaghan) 561**

**November 12, 1991, Argued**
**April 13, 1992, Decided**

**PRIOR HISTORY:** **[**1]** Appeal from a judgment for the defendant bank in the United States District Court for the Southern District of New York (John M. Cannella, Judge), following a bench trial. Appellants claim that the bank breached contractual commitments to provide letter of credit financing and violated a duty of good faith and fair dealing. We affirm.

**DISPOSITION:** Affirmed

**COUNSEL:** MAURICE N. ROSS, Shea & Gould, New York, New York, for Plaintiff-Appellant and Third-Party Defendant-Appellant.

MELVIN A. BROSTERMAN, Stroock & Stroock & Lavan, New York, New York, for Defendant-Appellee.

**JUDGES:** Before: LUMBARD, NEWMAN and WINTER, Circuit Judges.

**OPINION BY:** WINTER

**OPINION**

**[*1053]** WINTER, *Circuit Judge:*

Plaintiff-appellant Fasolino Foods Co., Inc. ("Appellant" or "FFC") and third-party defendant-appellant Antonio R. Fasolino ("Appellant" or "Fasolino") appeal from an adverse decision after a bench trial before Judge Cannella. FFC and Fasolino sought damages resulting from alleged breaches by Banca Nazionale del Lavoro ("BNL") of a commitment to provide certain financing and of implied duties of good faith and fair dealing. We affirm.

BACKGROUND

FFC is a New Jersey corporation that imports and distributes food products from Italy. Fasolino, a resident of New **[**2]** Jersey, is FFC's president and sole shareholder. BNL is a banking corporation, owned by the government of Italy, which does business in New York.

In late 1988, Fasolino met with Francesco Ingargiola, a BNL account officer, and Stephano Felicori, the head of BNL's commercial credit department, to discuss FFC's request for a $ 4 million line of credit to finance its importing of products from Italy for Anderson Clayton/Humko Products, Inc., a wholly-owned subsidiary of Kraft, Inc. We style this line of credit the "Kraft line of credit." A second request for a line of credit to finance FFC's non-Kraft business also appears to have been discussed at various times. We style this line of credit the "general line of credit."

Ingargiola and Felicori sought financial information

concerning FFC and a personal guaranty of all loans by Fasolino. The financial statements provided were unaudited, and BNL requested that Fasolino sign them to attest to their accuracy, which he did. Fasolino also executed the guaranty. A standing letter of credit agreement ("LOC Agreement") was signed by Fasolino on FFC's behalf and delivered to BNL on January 14, 1989. The LOC Agreement **[*1054]** contained terms and conditions **[**3]** applicable to all letters of credit--whether under the Kraft or general lines of credit--issued by BNL to FFC. Section 4 of the LOC Agreement, titled "Acceleration in Event of Default," stated that FFC would be considered in default if it failed to perform any obligation to BNL. The LOC Agreement further stated that in the event of default, obligations "shall become due and payable without presentment, demand, protest or other notice of any other kind, all of which we [FFC] hereby expressly waive." Section 6 of the LOC Agreement stated that "Failure to exercise and/or delay in exercising on your [BNL's] part, any right, power or privilege hereunder . . . shall not constitute a waiver thereof."

Judge Cannella found that, after BNL's Regional Credit Committee received the LOC Agreement, it recommended that the New York branch Credit Committee approve a $ 1 million Kraft line of credit. The reduction of the amount from $ 4 million appears due to the structure of the Kraft transaction, which, in BNL's view, would never involve more than $ 1 million in outstanding credit if the required payments were timely made. The New York branch Credit Committee approved the $ 1 million Kraft line **[**4]** of credit on March 3, 1989. This approval was conditioned upon the requirement that the Kraft line of credit be secured by a standby letter of credit issued for the benefit of BNL by a suitable bank acting on Kraft's behalf. Ingargiola telephoned Fasolino to notify him of the approval in the second week of March. Appellants claim on appeal that a $ 4 million Kraft line of credit was approved. Judge Cannella's findings are not clearly erroneous for reasons stated *infra.*

Whatever its parameters, the Kraft line of credit appears never to have been used. The credit was limited to the financing of goods imported by FFC for Kraft, but it appears that no such goods were ever imported. Moreover, Kraft never opened a standby letter of credit in BNL's name, as BNL had required as a condition to the opening of the Kraft line of credit. A letter of credit was established but only in favor of FFC, not BNL. The standby letter of credit, therefore, did not protect BNL.

However, FFC also claims that BNL made an oral commitment to open a $ 5 million general line of credit for non-Kraft business. Judge Cannella found that no such commitment was made. As discussed *infra,* that finding is not clearly **[**5]** erroneous.

Nevertheless, BNL did issue letters of credit to finance FFC's non-Kraft business. These letters of credit were governed by the LOC Agreement, which required that FFC remit payment in full upon maturity or have sufficient funds in its checking account with BNL to cover amounts due. FFC was rarely in compliance with these conditions and was routinely in an overdraft situation notwithstanding the lack of an overdraft line of credit with BNL. FFC's payments were on average thirty-six days late through the summer of 1989. Despite these late payments, BNL issued over twenty letters of credit in part on the fact that although payment was not timely, the money was ultimately received. Moreover, the credit relationship with FFC was perceived as offering BNL an opportunity to begin a business relationship with Kraft. Finally, the debt was personally guaranteed by Fasolino.

On October 25, 1989, FFC applied for two more letters of credit--one for $ 234,720.00 and one for $ 105,187.50. BNL began processing these requests, and, when the applications were introduced as exhibits at trial, they contained notations by BNL officers that FFC contends were indications of final approval. However, **[**6]** Judge Cannella found that the notations reflected only that the particular officers had either simply read the application or given at best preliminary approval. Meanwhile, FFC significantly increased the amounts requested. As of November 17, the additional letters of credit requested by FFC were for $ 169,917.00 and $ 469,440.00 or a total of $ 639,357.00. The largest previous request for a letter of credit had been in the amount of $ 211,075.00, and the new requests, if approved, would have substantially increased FFC's outstanding debt to BNL. Moreover, FFC was at this time in **[*1055]** its usual overdraft situation. On November 17, BNL officers advised FFC that approval of the additional letters of credit would be conditioned on BNL receiving adequate security to minimize its risk, specifically, a standby letter of credit in BNL's name. They also demanded payment of the overdraft amounts.

On November 30, house counsel for FFC threatened litigation against BNL if the bank did not comply with an alleged commitment to a "$ 4 million" line of credit. Attached to his letter was correspondence said to establish the existence of the "$ 4 million" line of credit. FFC failed to provide BNL with **[**7]** additional security in connection with this request and, therefore, on December 7, 1989, BNL informed FFC that the additional letters of credit would not be approved. FFC then stopped payments to BNL due on matured letters of credit, along with payments for commissions it owed BNL.

On January 19, 1990, FFC brought the instant action against BNL. FFC claimed that BNL breached its contractual commitment to a $ 5 million general line of credit, that it violated its duty of good faith and fair dealing in its banking relationship with FFC, and that it made negligent and/or fraudulent misrepresentations to FFC regarding its intention to provide a $ 5 million general line of credit. BNL counterclaimed, seeking recovery for matured letters of credit and various related commissions and charges. BNL also sought to recover from Fasolino as guarantor of FFC's liabilities. Appellants did not contest their liability to BNL and stipulated to the amount of damages.

On March 20, 1991, following a five-day bench trial, Judge Cannella found against FFC on each of its claims and for BNL on its counterclaim. FFC and Fasolino were held jointly and severally liable for the stipulated sum of $ 1,289,579.93, **[**8]** and for interest from March 30, 1990 in the stipulated amount of $ 164,665.74. The district court also ordered payment of attorney's fees to BNL in the amount of $ 197,284.35. FFC and Fasolino appealed.

DISCUSSION

Appellants argue that it was clearly erroneous for the district court not to have found, based on Fasolino's and a third-party witness's testimony and three pieces of correspondence, that BNL agreed to provide a $ 4 million Kraft line of credit and a $ 5 million general line of credit. We disagree.

In bench trials, "findings of fact, whether based on oral or documentary evidence, shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses." Fed. R. Civ. P. 52(a). In *Anderson v. City of Bessemer City,* 470 U.S. 564, 84 L. Ed. 2d 518, 105 S. Ct. 1504 (1985), the Supreme Court reemphasized that a reviewing court should not examine findings of fact *de novo:* "If the district court's account of the evidence is plausible in light of the record viewed in its entirety, the court of appeals may not reverse . . . ." *Id.* at 573-74. With regard to credibility determinations, **[**9]** the Court stated that "only the trial judge can be aware of the variations in demeanor and tone of voice that bear so heavily on the listener's understanding of and belief in what is said." 470 U.S. at 575.

Judge Cannella found that the only line of credit approved by BNL was the $ 1 million Kraft line of credit. Judge Cannella disbelieved Fasolino's testimony regarding a $ 4 million Kraft line of credit and a $ 5 million general line of credit, and in this case we will not disturb findings that are based on the district court's credibility determinations. The documents proffered by Fasolino in support of his claim of a $ 4 million Kraft line of credit and a $ 5 million line of credit consisted of three letters to BNL allegedly written by him. [1] Judge **[*1056]** Cannella determined that all three were fabrications created after the fact for purposes of this litigation. There is substantial evidence to support his finding. For example, none of the letters were found in BNL's files, and the only evidence of their having been mailed was Fasolino's discredited testimony. Moreover, none of the letters were produced by FFC in the initial document exchange although they were supposedly **[**10]** in Fasolino's possession and were the only documents supportive of his claim at trial. One letter bore the same Federal Express invoice number as another letter (with a different date) that was received by BNL, and Judge Cannella reasonably found that the two letters were not mailed together. Another letter not received by BNL was purportedly typed by Fasolino's secretary on the same day that his wife typed and mailed a letter that was received by BNL. The latter did not mention the former. Finally, when counsel for FFC set out in a letter FFC's understanding of BNL's commitments based on attached documents, the correspondence in question was not attached, although at trial it was central to appellants' evidentiary proffer. Judge Cannella's finding of fabrication was, therefore, not clearly erroneous.

1 The continued argument over the size of the approved Kraft line of credit is puzzling in light of its seeming irrelevance. The argument may continue because the three letters refer to the $ 4

million Kraft line of credit, and, if Judge Cannella's finding of only a $ 1 million Kraft line of credit stands, the letters might be discredited in their entirety on that ground alone.

**[**11]** The strongest evidence supporting the claim of a larger line of credit was testimony by a disinterested third party that Ingargiola had told him that FFC had a "medium 7 figure"--$ 4 million to $ 5 million--unsecured letter of credit. However, the district court was not obliged as a matter of law to credit this evidence and ignore the evidence to the contrary. The possibility of errors in communication cannot be excluded, particularly where the Kraft line of credit was intended to finance $ 4 million of business but was limited to $ 1 million of credit outstanding at any time.

We therefore uphold the district court's determination that appellants failed to prove an express agreement to provide FFC with a $ 4 million Kraft line of credit and $ 5 million general line of credit. [2] There was thus no express obligation on BNL's part to approve any letters of credit on non-Kraft business.

2 Because Judge Cannelia found that no such representations were made by BNL, appellants' claims based on negligent misrepresentation and fraud must be rejected.

**[**12]** This determination disposes of appellants' argument that BNL breached a duty of good faith and fair dealing, implied by its alleged express contractual relationship with FFC, by not approving the additional letters of credit. Under New York law, parties to an express contract are bound by an implied duty of good faith, "but breach of that duty is merely a breach of the underlying contract." *Geler v. National Westminster Bank USA,* 770 F. Supp. 210, 215 (S.D.N.Y. 1991) (citations omitted). Moreover, New York Uniform Commercial Code § 5-109 provides: "An issuer's obligation to its customer includes good faith and observance of any general banking usage . . . ." *See also* N.Y. U.C.C. Law § 1-203 (duty of good faith applies to enforcement and performance of contracts). However, the Official Comment to Section 5-109 states: "The extent of the issuer's obligation to its customer is based upon the agreement between the two." N.Y. U.C.C. Official Comment 1 (McKinney 1991).

Given Judge Cannella's findings, the only express agreements before us are the $ 1 million Kraft line of credit and the LOC Agreement. The applications in question were for non-Kraft business, and **[**13]** whatever obligations to act in good faith the Kraft line of credit might have implied are not relevant. The LOC Agreement arguably embodies a duty of good faith with regard to existing letters of credit, but no justifiable inference can be drawn from its terms obligating BNL to apply any particular standards in evaluating applications for further credit. BNL thus did not violate any duty of good faith implied from the express contracts before us.

Appellants' express contract claim also founders on their failure to comply with the LOC Agreement. FFC's overdrafts were defaults entitling BNL not only to decline further extensions of credit **[*1057]** but also to accelerate the payment of existing debt. Even if BNL were committed to a $ 5 million general line of credit, it was still entitled to timely payment and, once overdrafts occurred, to decline further extensions of credit and accelerate payments or to insist on the lesser measure of requiring greater security.

As Judge Posner has recently written: "Even after you have signed a contract, you are not obliged to become an altruist toward the other party and relax the terms if he gets into trouble in performing his side of the bargain." *Market Street Assocs. Ltd. Partnership v. Frey,* 941 F.2d 588, 594 (7th Cir. 1991) **[**14]** (citing *Kham & Nate's Shoes No. 2. Inc. v. First Bank,* 908 F.2d 1351, 1357 (7th Cir. 1990)). When FFC applied for the letters of credit in issue, it was in violation of the LOC Agreement and in default. It was, therefore, not in a position to demand as a matter of right BNL's extension of further credit, even if an agreement as to a $ 5 million general line of credit existed.

We also read appellants to advance an implied contract argument based on the parties' course of dealing in which BNL approved numerous applications by FFC for letters of credit, usually in overdraft situations. This implied agreement is itself said to entail an obligation to act in good faith and to require BNL to approve the applications at issue, at least in the absence of sufficient advance notice. The argument is unsupported by New York case law, the U.C.C., or common sense.

BNL's prior approval of FFC's applications for letters of credit in overdraft situations hardly implies a continuing obligation to issue future such letters, much less an obligation to increase the amount of credit extended. What obligation BNL might have had if FFC

had made timely payments is not before us. However, **[**15]** a rule that banks may not issue letters of credit to a defaulting borrower without obligating themselves to issue yet more letters in the future would help the borrower in this case but would work to the detriment of future borrowers. Such a rule would disable banks from ending risky financing relationships and cutting their losses, causing the banks either to charge greater interest to compensate for the greater risk or to be more selective in initiating financing relationships, or both. Indeed, Section 6 of the LOC Agreement states that BNL does not waive its rights by non-enforcement. We see no reason not to give that provision its plain meaning. Indeed, a contrary view would discourage lenders from allowing borrowers leeway and encourage those lenders to play hardball in the face of every default, no matter how minor. Furthermore, even if the payments had been timely, an obligation on BNL's part to increase the outstanding debt cannot be implied. Such an obligation would require BNL to extend credit that had been requested but never agreed to.

Appellants also argue that the obligation to act in good faith resulting from the implied agreement based on the parties' course of dealing **[**16]** bound BNL to give FFC notice of disapproval sufficient to allow it to obtain alternative financing. In making this argument, appellants rely principally upon *K.M.C. Co. v. Irving Trust Co.,* 757 F.2d 752 (6th Cir. 1985). In *K.M.C.,* Irving Trust had entered into an agreement with K.M.C. to extend a line of credit not to exceed $ 3.5 million. The agreement required K.M.C. to deposit all receipts into a blocked account, to which only Irving Trust had access. After K.M.C. withdrew $ 2.7 million according to the terms of the agreement, K.M.C. sought to withdraw the remaining $ 800,000. At that point and without any advance notice, Irving Trust refused to release the funds to K.M.C., leading to the latter's demise. The Sixth Circuit ruled that under the line of credit agreement, Irving Trust was under a good faith obligation to give notice to K.M.C. that it would not advance more funds sufficient to allow K.M.C. to obtain other financing.

We do not pause to address the validity of the K.M.C. analysis because the decision is easily distinguishable. First, *K.M.C.* involved an agreed-upon line of credit of $ 3.5 million. In the instant matter, the only express agreement **[**17]** for a line of credit was **[*1058]** the Kraft $ 1 million line of credit, and the applications in question were for non-Kraft business. Unlike the parties in *K.M.C.,* therefore, BNL never represented that credit of a certain amount would be provided, and FFC had no reasonable expectation of continued, much less expanded, credit in overdraft situations.

Second, *K.M.C.* involved a

'blocked account' mechanism [that] would leave K.M.C.'s continued existence entirely at the whim or mercy of Irving, absent an obligation of good faith performance. Logically, at such time as Irving might wish to curtail financing K.M.C., as was its right under the agreement, this obligation to act in good faith would require a period of notice to K.M.C. to allow it a reasonable opportunity to seek alternate financing.*Id.* at 759. In *K.M.C.,* therefore, the court viewed the blocked account as a barrier to K.M.C.'s obtaining credit elsewhere and apparently contemplated, as part of the required notice, a release of the blocked funds to the extent they exceeded the outstanding debt. In the instant matter, BNL controlled none of FFC's assets, and BNL could not impede FFC's seeking credit **[**18]** elsewhere. Indeed, FFC had notice in mid-November that BNL wanted the overdraft situation redressed and more security provided before issuing letters of credit that would increase FFC's outstanding debt to BNL. FFC was at that time completely free to seek credit elsewhere.

Finally, appellants also ask us to remand for a new trial on the entirely meritless ground that "the District Court's wholly conclusory disposition of FFC's claims" did not comply with Fed. R. Civ. P. 52(a). Rule 52(a) states, in relevant part: "In all actions tried upon the facts without a jury . . . the court shall find the facts specially and state separately its conclusions of law thereon." Fed R. Civ. P. 52(a). The district court clearly fulfilled this obligation in nineteen pages of lucid factual findings and another ten pages of well-supported legal conclusions. All that is required by Rule 52(a) is that the trial court provide findings that are adequate to allow a clear understanding of its ruling. *See Fluor Corp. v. United States ex rel. Mosher Steel Co.,* 405 F.2d 823, 828 (9th Cir.), *cert. denied,* 394 U.S. 1014, 23 L. Ed. 2d 40, 89 S. Ct. 1632 (1969); *see also SquirtCo v. Seven-Up Co.,* 628 F.2d 1086 (8th Cir. 1980) **[**19]** (failure to find facts specially is ground for vacatur and remand where facts are disputed). Judge Cannella's thorough opinion easily met that test.

Affirmed.

# TAB 11

**LOUISE M. HARRIS, Plaintiff-Counter-Defendant-Appellee, v. PROVIDENT LIFE AND ACCIDENT INSURANCE COMPANY, Defendant-Counter-Claimant-Appellant, PROVIDENT COMPANIES, INC., Defendant-Appellant.**

**Docket No. 01-9265**

**UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT**

**310 F.3d 73; 2002 U.S. App. LEXIS 22541**

**August 28, 2002, Argued**
**October 29, 2002, Decided**

**SUBSEQUENT HISTORY:** Related proceeding at Harris v. First Unum Life Ins. Co., 2004 U.S. Dist. LEXIS 10245 (N.D.N.Y, June 4, 2004)
Subsequent appeal at Harris v. Provident Life & Accident Ins. Co., 2004 U.S. App. LEXIS 20870 (2d Cir. N.Y., Oct. 6, 2004)

**PRIOR HISTORY:** **[**1]** Anesthesiologist brought claim against her disability insurance carrier in the United States District Court for the Northern District of New York, Hurd, J., alleging breach of contract and breach of the implied covenant of good faith and fair dealing, where the insurer denied payment of disability benefits. Insurer counterclaimed for rescission on the basis of nondisclosure of material facts by anesthesiologist. The district court granted summary judgment to plaintiff on the breach of contract claim on the grounds that no genuine issue of material fact existed as to whether plaintiff was disabled. The district court dismissed the breach of implied covenant claim and the insurer's counterclaim. The Court of Appeals vacates the district court's grant of summary judgment on the breach of contract claim and remands for further proceedings on that claim, and affirms the district court's dismissal of the breach of implied covenant claim and defendants' counterclaim.
Harris v. Provident Life & Accident Ins. Co., 166 F. Supp. 2d 733, 2001 U.S. Dist. LEXIS 15617 (N.D.N.Y, 2001)

**DISPOSITION:** Judgment of the district court vacated in part, affirmed in part, and remanded.

**COUNSEL:** ARTHUR J. SIEGEL, Albany, NY, (Bond, Schoeneck & King, Albany, NY, of counsel), for Appellant Provident Life and Accident Ins. Co.

Jean F. Gerbini, Joel L. Hodes, Melvin H. Osterman, Heather D. Diddel, Whiteman Osterman **[**2]** & Hanna, Albany, NY, on the brief, for Appellee Louise M. Harris.

**JUDGES:** Before: MESKILL, CARDAMONE and STRAUB, Circuit Judges.

**OPINION BY:** MESKILL

**OPINION**

**[*74]** MESKILL, *Circuit Judge*:

Defendants-appellants Provident Life and Accident Insurance Co. and Provident Companies, Inc. (collectively "Provident") appeal from an order of the United States District Court for the Northern District of New York, Hurd, *J.*, granting plaintiff-appellee Louise M. Harris' (Harris) motion for summary judgment on the

first count of the complaint, denying Provident's **[*75]** cross-motion for summary judgment, and dismissing Provident's counterclaim. Harris has cross-appealed the district court's dismissal of the second count of the complaint. Jurisdiction is premised on diversity of citizenship pursuant to 28 U.S.C. § 1332(a)(1), Harris being a citizen of New York, each Provident entity being a Delaware corporation, and the claimed damages exceeding $ 75,000. We have appellate jurisdiction pursuant to 28 U.S.C. § 1291 as this is an appeal from a final judgment of the district court.

The first count of the complaint alleges that Provident breached its contract with Harris **[**3]** by refusing to pay her disability benefits pursuant to an insurance policy. The district court found that Harris was entitled to summary judgment on this claim, as she had established that no genuine issue of material fact existed as to whether she was totally disabled. The second count of the complaint alleges that Provident breached the implied covenant of good faith and fair dealing by refusing to pay Harris disability benefits. The district court found that Provident was entitled to summary judgment on this claim, because under New York law, a claim for breach of the implied covenant is duplicative of a breach of contract claim. Provident's counterclaim seeks rescission of the insurance contract based on an allegation that Harris withheld material information regarding her medical condition from Provident. The district court granted summary judgment on this claim to Harris and dismissed the counterclaim in its entirety.

We conclude that the district court erred in finding that no genuine issue of material fact exists as to whether Harris is totally disabled and entitled to disability payments under the insurance policy. We therefore vacate the district court's order granting summary **[**4]** judgment in favor of the plaintiff on the first count of the complaint and remand the case for further proceedings on that count only. We affirm the district court's order dismissing the second count of the complaint and dismissing Provident's counterclaim.

BACKGROUND

Harris is a medical doctor, specifically, an anesthesiologist. As such, she was required to work long shifts. Her tasks were physically and mentally demanding. Because she worked in surgical procedures, Harris was required to use and was surrounded by latex products. At the time Harris claims to have become disabled, she was working approximately 60 hours per week and earning over $ 200,000 annually.

In 1992, while living and working in California, Harris entered into a disability insurance contract with Provident, whereby Harris would receive benefits if she became unable to work as an anesthesiologist. At the time Harris claims to have become disabled, the insurance policy provided benefits in the amount of $ 10,560 per month if Harris became "totally disabled." The insurance policy states that a covered person is "totally disabled" if she is "not able to perform the substantial and material duties of [her] occupation[] **[**5]** and [she is] receiving care by a Physician which is appropriate for the condition causing the disability." The policy further states that "occupation" means the occupation in which the covered person is engaged at the time she becomes disabled, including the person's specialty.

On or about March 16 and 17, 1998, Harris was working at Glens Falls Hospital as the staff anesthesiologist. During her shift, Harris worked primarily in the Obstetrics Department, but also went in and out of the Operating Room for various procedures. At that time, the Obstetrics Department was undergoing major construction **[*76]** for latex abatement, which made the area very dusty. Harris began to feel ill and to have difficulty breathing. Harris continued to feel ill for several days, and on March 19, 1998 she was examined by Dr. Michael Slaughter, an allergist. Dr. Slaughter informed Harris that he believed she had asthma, which he believed could have been induced by an allergy to latex.

Between March 19, 1998 and May 4, 1998, Harris attempted to work as an anesthesiologist both at Glens Falls Hospital and at another area hospital, avoiding the construction area at Glens Falls. Throughout that time period, **[**6]** Harris avoided using latex gloves, and took medication to treat her symptoms. On May 4, 1998, Harris returned to Dr. Slaughter after having difficulty breathing at work. Dr. Slaughter advised Harris to stop working. Harris has not worked as an anesthesiologist since that date.

On or about May 16, 1998, Harris submitted a claim to Provident asserting, in a physician's statement prepared by Dr. Slaughter, that she had become unable to work due to "latex induced asthma, plus latex anaphylactoid reaction, plus latex contact reactivity, plus allergic rhinitis." Provident paid preliminary disability benefits to

Harris for the period from May 4, 1998 through September 3, 1998, but informed Harris that she would have to provide proof of continuing disability on a monthly basis.

In September 1998, Dr. James DeMasi, an allergist and asthma specialist, evaluated Harris at Provident's request. [1] Dr. DeMasi testified at his deposition that he was retained by Provident to determine whether Harris had a latex allergy; he was not specifically asked to determine whether Harris had asthma, but the presence or absence of asthma was part of the evaluation because it may be a symptom of latex allergy. **[**7]** Dr. DeMasi found no evidence that Harris was allergic to latex, but suspected that Harris "may have some asthma." Dr. DeMasi also suspected that Harris had an anxiety disorder which included a perception of a latex allergy. Dr. DeMasi tested Harris' lung capacity, which was normal, and determined that whatever asthma Harris might have was triggered by dust or other irritants other than latex. On the basis of these findings, Provident denied Harris' application for benefits, notifying Harris of its decision by a letter she received on or about October 24, 1998. Harris appealed the denial to Provident's review board, which affirmed the decision to deny benefits on November 18, 1998, noting that Harris had not presented any new evidence that she was in fact totally disabled.

1 Dr. DeMasi testified at his deposition that he had not done any other medical review for Provident other than Harris', and that he had done approximately 6 such reviews for other companies in his career.

After receiving Dr. DeMasi's initial **[**8]** report, Harris wrote to Provident requesting that she be evaluated by one of four experts, including one from Johns Hopkins and one from the Mayo Clinic, whom she considered "the most prominent names in the literature on latex allergy." Provident declined to have Harris evaluated by any of these experts.

On October 15, 1998, Harris visited Johns Hopkins on her own initiative and was evaluated by Dr. Franklin Adkinson. The tests performed by Dr. Adkinson did not support a finding that Harris was allergic to latex. Dr. Adkinson diagnosed Harris as having suffered an "acute pulmonary insult" as a result of the construction at Glens Falls Hospital. Dr. Adkinson's secondary diagnosis was asthma, and his **[*77]** tertiary diagnosis was a possible latex allergy. Dr. Adkinson advised Harris orally at the time of his evaluation that he felt she could return to work and "see how she does." Dr. Adkinson produced a written report of his findings on January 5, 1999, which he sent to Harris and Dr. Slaughter. Harris did not inform Provident of the results of Dr. Adkinson's evaluation or disclose his report until required to do so by an order of the district court dated December 20, 2000.

On June 30, 1999, Harris **[**9]** went to the Mayo Clinic on her own initiative and was evaluated by Dr. Loren Hunt. Dr. Hunt found no evidence of latex sensitivity. Dr. Hunt also reported that Harris' treadmill testing, echocardiogram, pulmonary artery pressure and other tests were all normal. Dr. Hunt's report stated that Harris' "health appeared to be quite good," and did not recommend that Harris take any medications. Dr. Hunt advised Harris that she could return to work at Glens Falls Hospital after construction there was completed. Harris did not inform Provident of the results of the Mayo Clinic evaluation until required to do so by an order of the district court dated December 20, 2000.

Harris initiated litigation against Provident in the United States District Court for the Northern District of New York on July 15, 1999, claiming that Provident had breached its contract with her by refusing to pay her disability benefits, and that Provident had also breached the covenant of good faith and fair dealing implicit in that contract. Provident filed a counterclaim contending that it was entitled to rescission of the insurance contract because Harris had failed to inform Provident of the results of her testing at **[**10]** Johns Hopkins and the Mayo Clinic in a timely manner. Harris moved for summary judgment on the breach of contract claim and on Provident's counterclaim. Provident moved for summary judgment on both counts of the complaint and on its counterclaim.

On December 14 and 15, 2000, after the commencement of the instant litigation, Harris was evaluated by Dr. Irwin Berlin of Trinitas Hospital. Dr. Berlin found no problems in Harris' cardio-pulmonary function, but concluded that Harris "had a positive latex (NRL) challenge." This report was made available to Provident during litigation.

In support of its opposition to Harris' motion for summary judgment, Provident submitted an expert report prepared by Dr. DeMasi, which reviewed and summarized the findings of the other doctors who evaluated Harris, as well as his own findings. [2] Dr.

DeMasi concluded that "there is no objective medical evidence that Dr. Harris is disabled by asthma, allergic to latex, or unable to work in a hospital environment."

> 2 Harris contends that this report should have been stricken because Provident failed to disclose the basis for the report as required by Fed. R. Civ. P. 26(a)(2). Provident contends that it should be permitted to submit the supplemental report because Dr. DeMasi's original report focused on the question whether Harris suffered from a latex allergy. Once Harris shifted her claim from one of disabling latex allergy to one of disabling asthma, a shift which the district court followed, Provident contends it was entitled to submit a supplemental report addressing this new theory of the claim. The district court deemed the supplemental report admissible for purposes of the summary judgment motion, and we review that decision only for manifest error. *See Raskin v. Wyatt Co.*, 125 F.3d 55, 65-67 (2d Cir. 1997). No such error is present here. However, even if Dr. DeMasi's supplemental report is not admissible, there exist genuine issues of material fact sufficient to preclude summary judgment in favor of Harris.

**[**11]** **[*78]** The district court held that it was irrelevant whether Harris suffered from a latex allergy. The district court found that Harris had established that no genuine issue of material fact existed as to whether she was totally disabled from working as an anesthesiologist due to severe asthma, and that Harris therefore was entitled to judgment as a matter of law on the first count of her complaint. The district court dismissed Harris' second claim for breach of the implied covenant of good faith and fair dealing in a footnote, on the grounds that under New York law, such a claim is duplicative of a claim for breach of contract. Finally, the district court granted summary judgment in favor of Harris on Provident's counterclaim on the grounds that the information withheld by Harris was not material.

This appeal and cross-appeal followed.

DISCUSSION

I. *Standard of Review*

"As the analysis required for summary judgment is a legal one, we review *de novo* the district court's grant of summary judgment, construing the evidence in the light most favorable to the nonmoving party. Summary judgment is appropriate if there are no genuine issues of material fact and the movant is entitled **[**12]** to judgment as a matter of law." *Caldarola v. Calabrese*, 298 F.3d 156, 160 (2d Cir. 2002) (internal citations and quotation marks omitted). "The issue of material fact required by Rule 56(c) to be present to entitle a party to proceed to trial is not required to be resolved conclusively in favor of the party asserting its existence; rather, all that is required is that sufficient evidence supporting the claimed factual dispute be shown to require a jury or judge to resolve the parties' differing versions of the truth at trial." *First Nat'l Bank of Ariz. v. Cities Serv. Co.*, 391 U.S. 253, 288-89, 20 L. Ed. 2d 569, 88 S. Ct. 1575 (1968). In ruling on a motion for summary judgment, "the district court must view the evidence in the light most favorable to the party opposing summary judgment and must draw all permissible inferences from the submitted affidavits, exhibits, interrogatory answers, and depositions in favor of that party. If, as to the issue on which summary judgment is sought, there is any evidence in the record from which a reasonable inference could be drawn in favor of the opposing party, summary judgment is improper." *Gummo v. Village of Depew, N.Y.*, 75 F.3d 98, 107 (2d Cir. 1996) **[**13]** (internal citations omitted).

II. *Harris' First Claim: Breach of Contract*

The primary dispute in this case is whether Harris is entitled to payments under the disability insurance policy she had with Provident; in other words, is Harris "not able to perform the substantial and material duties of [her] occupation" as an anesthesiologist. As the moving party, Harris bears the burden of establishing that no genuine issue of material fact exists as to whether she is totally disabled under the policy; any ambiguity is to be resolved in favor of Provident. *See Carlton v. Mystic Transp.*, 202 F.3d 129, 133 (2d Cir. 2000). Further, "not only must there be no genuine issue as to the evidentiary facts, but there must also be no controversy regarding the inferences to be drawn from them." *Donahue v. Windsor Locks Bd. of Fire Comm'rs*, 834 F.2d 54, 57 (2d Cir. 1987). Upon *de novo* review, we conclude that genuine issues of material fact exist as to whether Harris is totally disabled, and summary judgment on this claim in her favor should not have been granted.

In support of her motion for summary judgment, Harris submitted the opinions **[*79]** of Dr. Slaughter,

**[**14]** her treating allergist, and Dr. Desmond DelGiacco, her treating pulmonologist. Each of these doctors stated that it was his opinion that Harris was totally disabled due to latex-induced asthma and unable to work as an anesthesiologist. Harris also produced the report of Dr. Berlin, which concluded that Harris was allergic to latex.

In opposition to Harris' motion, Provident produced the medical evaluation of Dr. DeMasi, as well as the reports of the evaluations performed at Johns Hopkins and the Mayo Clinic. Each of these evaluations found no evidence that Harris was allergic to latex, and found Harris' pulmonary function to be normal. Dr. DeMasi, Dr. Adkinson and Dr. Hunt each found that Harris could return to work, at least after the construction at Glens Falls Hospital was completed.

This disagreement among the doctors who evaluated Harris gives rise to a genuine issue of material fact as to (1) what disability, if any, affects Harris, and (2) whether that disability totally disables her from working as an anesthesiologist. The district court erroneously stated that Provident relied solely on Dr. DeMasi's opinion in opposing summary judgment, and that because Dr. DeMasi made **[**15]** no finding as to whether Harris was disabled because of asthma, his opinion did not give rise to a genuine issue of material fact. "Where, as here, there are conflicting expert reports presented, courts are wary of granting summary judgment." *Hudson Riverkeeper Fund v. Atlantic Richfield Co.*, 138 F. Supp. 2d 482, 488 (S.D.N.Y. 2001). *See also B.F. Goodrich v. Betkoski*, 99 F.3d 505, 527 (2d Cir. 1996) (denying summary judgment where expert affidavit raised genuine issue of material fact); *Iacobelli Constr. v. County of Monroe*, 32 F.3d 19, 25-26 (2d Cir. 1994) (same); *In re Joint E. & S. Dist. Asbestos Litig.*, 964 F.2d 92, 96 (2d Cir. 1992) (same); *Jiminez v. Dreis & Krump Mfg. Co.*, 736 F.2d 51, 54 (2d Cir. 1984) (same). Considering the Mayo Clinic and Johns Hopkins reports in conjunction with Dr. DeMasi's opinion, as is appropriate, and drawing all reasonable inferences in favor of Provident as the nonmoving party, we find that the district court erred in granting summary judgment in favor of Harris on this claim.

The district court focused solely on the issue whether Harris suffered from asthma, as **[**16]** opposed to *latex-induced* asthma. The original Notice of Claim filed by Harris with Provident includes a statement from Dr. Slaughter which repeatedly refers to Harris' disability as being related to latex. The form poses the following question: "What restrictions or limitations, if any, are there on your patient's ability to perform the duties of his/her occupation, and why?" In response, Dr. Slaughter wrote: "Patient has become hypersensitive to airborne concentrations of latex. The hospitals and medical facilities where she performs her duties are major repositories of latex antigens. The patient develops significant coughing, wheezing and [illegible] onset March 16-98, ceased work on our direction 5-5-98." Dr. Slaughter did not mention asthma as a reason for Harris' inability to work in the claim form. Thus, when Harris applied for benefits, she applied on the grounds that she was allergic to latex and therefore unable to work in the latex-intensive environment of a hospital. Provident evaluated Harris' claim for benefits accordingly. Provident's expert determined that Harris was not allergic to latex, and Harris' own physician could not state unequivocally that Harris **[**17]** was allergic to latex. Harris' claim was therefore denied.

There is ample evidence in the record to raise a genuine issue of material fact as to whether Harris is severely allergic to latex. **[*80]** There is also sufficient evidence to raise a genuine issue of fact as to whether Harris is totally disabled by asthma. Although Dr. DeMasi, Johns Hopkins and the Mayo Clinic evaluated Harris primarily for latex sensitivity, each also performed testing on Harris' pulmonary functioning, as asthma is often a symptom of latex sensitivity, and Harris had specifically complained of breathing difficulty. Each of these evaluations found Harris to be in good pulmonary health. Dr. DeMasi and Johns Hopkins found that it was possible that Harris did suffer from some asthma; however, none of these three experts found that Harris suffered from severe or debilitating asthma, and each recommended she return to work. The district court's order granting summary judgment on this claim is therefore vacated, and this case is remanded for further proceedings on Harris' breach of contract claim.

III. *Harris' Second Claim: Breach of the Implied Covenant of Good Faith and Fair Dealing*

The second count of Harris' **[**18]** complaint alleges that Provident breached the covenant of good faith and fair dealing implied in the disability insurance contract between Harris and Provident. "Under New York law, parties to an express contract are bound by an

implied duty of good faith, but breach of that duty is merely a breach of the underlying contract." *Fasolino Foods Co. v. Banca Nazionale del Lavoro*, 961 F.2d 1052, 1056 (2d Cir. 1992) (internal quotation marks and citations omitted). The district court found that Harris' claim for breach of the implied covenant was therefore duplicative of her claim for breach of contract, and dismissed the implied covenant claim accordingly. *See ICD Holdings S.A. v. Frankel*, 976 F. Supp. 234, 243-44 (S.D.N.Y. 1997) ("A claim for breach of the implied covenant will be dismissed as redundant where the conduct allegedly violating the implied covenant is also the predicate for breach of covenant of an express provision of the underlying contract.") (internal quotation marks omitted).

Harris has appealed the dismissal of this claim on two grounds. First, Harris points to a series of New York cases holding that, under certain circumstances, an **[**19]** insurer may be held liable by an insured or the insured's excess insurer for a bad faith failure to settle a claim. In *Pavia v. State Farm Mutual Automobile Ins. Co.*, 82 N.Y.2d 445, 453-54, 626 N.E.2d 24, 27-28, 605 N.Y.S.2d 208, 211-12 (1993), the court held that a plaintiff in such a case "must establish that the defendant insurer engaged in a pattern of behavior evincing a conscious or knowing indifference to the probability that an insured would he held personally accountable for a large judgment if a settlement offer within the policy limits were not accepted." *See also Geler v. Nat'l Westminster Bank USA*, 770 F. Supp. 210, 215 n.1 (S.D.N.Y. 1991) (noting that a cause of action exists in New York for "bad-faith failure to settle an insurance claim"). These cases are inapposite, as the bad faith claim they recognize is limited to cases in which an insurance company refuses to settle a claim *against the insured*, thereby exposing the insured or its excess insurer to unreasonable or unnecessary liability. Here, there is no claim against Harris; rather, Harris herself is the claimant. [3]

3 Harris also argues that under *Acquista v. New York Life Ins. Co.*, 730 N.Y.S.2d 272, 285 A.D.2d 73 (App. Div. 1st Dep't 2001), consequential damages are available for an insurer's bad faith denial of coverage. Even assuming *Acquista*'s holding is correct, *see Brown v. Paul Revere Life Ins. Co.*, 2001 U.S. Dist. LEXIS 16626, 2001 WL 1230528, at *5 (S.D.N.Y. Oct. 16, 2001) (calling *Acquista* inconsistent with New York law), Harris' complaint does not adequately plead a basis for the recovery of consequential damages. *See Kenford Co. v. County of Erie*, 73 N.Y.2d 312, 319, 537 N.E.2d 176, 178, 540 N.Y.S.2d 1, 3-4 (1989) (to recover damages beyond those flowing naturally from the breach, "such unusual or extraordinary damages must have been brought within the contemplation of the parties as the probable result of a breach at the time of or prior to contracting").

**[**20]** **[*81]** Harris also contends that "an appropriate conflict-of-laws analysis counsels the application of California law to this claim," and that under California law, breach of the implied covenant by an insurer may form the basis of a separate cause of action, distinct from a claim for breach of the contract itself. The insurance contract was signed in 1992 in California where she lived and worked at the time. Therefore, we must conduct a choice of law inquiry.

> Because our subject matter jurisdiction here is grounded on the diversity statute, and because the District Court whose judgment we are reviewing sits in New York, we must determine the body of substantive law that applies here with reference to New York's choice of law rules. *See Klaxon Co. v. Stentor Elec. Mfg. Co.*, 313 U.S. 487, 497, 61 S. Ct. 1020, 85 L. Ed. 1477 (1941). Under these rules, the first step in any choice of law inquiry is to determine whether there is an "actual conflict" between the laws invoked by the parties. *See In re Allstate Ins. Co.*, 81 N.Y.2d 219, 223, 597 N.Y.S.2d 904, 905, 613 N.E.2d 936 (1993). If there is such a conflict, the court must then classify the conflicting **[**21]** laws by subject matter with reference to New York law. *See, e.g., Tanges v. Heidelberg N. Am., Inc.*, 93 N.Y.2d 48, 54, 687 N.Y.S.2d 604, 606, 710 N.E.2d 250 (1999) (explaining that New York law determines whether, for choice of law purposes, a Connecticut statute of limitations is "substantive" or "procedural"); *see also, e.g., Martin v. Julius Dierck Equip. Co.*, 52 A.D.2d 463, 466-67, 384 N.Y.S.2d 479, 482 (2d Dept. 1976) (classifying a products-liability claim as sounding in

> tort, not contract). Having classified the conflicting laws, the court must then select and apply the proper body of choice of law rules.

*Booking v. Gen. Star Mgmt. Co.*, 254 F.3d 414, 419-20 (2d Cir. 2001). New York law, as discussed above, does not recognize a separate cause of action for breach of the implied covenant of good faith and fair dealing when a breach of contract claim, based upon the same facts, is also pled. Under California law, it is also normally the case that

> if the allegations [of breach of the implied covenant] do not go beyond the statement of a mere contract breach and, relying on the same alleged acts, simply seek the **[**22]** same damages or other relief already claimed in a companion contract cause of action, they may be disregarded as superfluous as no additional claim is actually stated.

*Careau & Co. v. Sec. Pac. Bus. Credit*, 222 Cal.App.3d. 1371, 1395, 272 Cal.Rptr. 387, 400 (1990). However, in California, unlike in New York, "in insurance cases there is a well-developed history recognizing a tort remedy for a breach of the implied covenant" where the insurer has acted "unreasonably or without proper cause." *Id.* (internal citations omitted). Thus, there is an actual conflict between the law of New York and the law of California. However, we need not determine which law applies, because under the law of either state, the district court was correct in dismissing the plaintiff's claim.

The Ninth Circuit has recently explained California law as follows:

> **[*82]**
>
> In order to establish a breach of the implied covenant of good faith and fair dealing under California law, a plaintiff must show: (1) benefits due under the policy were withheld; and (2) the reason for withholding benefits was unreasonable or without proper cause. The key to a bad faith claim is whether or not the insurer's **[**23]** denial of coverage was reasonable. Under California law, a bad faith claim can be dismissed on summary judgment if the defendant can show that there was a genuine dispute as to coverage[.] A court can conclude as a matter of law that an insurer's denial of a claim is not unreasonable, so long as there existed *a genuine issue as to the insurer's liability*.

*Guebara v. Allstate Ins. Co.*, 237 F.3d 987, 992 (9th Cir. 2001) (internal citations and quotation marks omitted).

When Harris filed her notice of claim with Provident in May 1998, the attached "Attending Physician's Statement," completed by Dr. Slaughter, identified the conditions suffered by Harris as "latex induced asthma, plus latex anaphylactoid reaction, plus latex contact reactivity, plus allergic rhinitis." On the same form, Dr. Slaughter indicated that the reason that Harris was unable to work was that she had "become hypersensitive to airborne concentrations of latex." Based on Dr. Slaughter's diagnosis, Provident made an initial payment under the policy to Harris for benefits from May 4, 1998 through September 3, 1998. In September 1998, Provident hired Dr. DeMasi to evaluate Harris for the **[**24]** condition which she had claimed rendered her unable to work: hypersensitivity to latex. Dr. DeMasi found that Harris was not allergic to latex. Based on this finding, Provident determined that it would not pay Harris any further benefits under the policy. Harris appealed this decision, and Provident's review board upheld the decision to deny benefits, based on Harris' failure to present any new medical evidence that would cause Provident to change its position.

"The reasonableness of the insurer's decisions and actions must be evaluated as of the time that they were made; the evaluation cannot fairly be made in the light of subsequent events which may provide evidence of the insurer's errors." *Chateau Chamberay Homeowners Ass'n v. Associated Int'l Ins. Co.*, 90 Cal.App.4th 335, 347, 108 Cal.Rptr.2d 776, 784 (2001). At the time Provident made its initial decision to deny coverage, in October 1998, and its decision to deny Harris' appeal of the denial, in November 1998, Provident had only Dr. DeMasi's report, Dr. Slaughter's diagnosis, and Harris' own statements on which to base its decisions. Harris also was evaluated by Johns Hopkins in October 1998, but she did not **[**25]** disclose that fact to Provident until months after Provident had reached its decision. As Dr. DeMasi noted, even Dr. Slaughter's diagnosis was equivocal, using terms such as "I believe" and "I suspect" that Harris had a latex

allergy, and Dr. Slaughter's own initial testing left him unable to confirm that Harris was actually allergic to latex.

A California appellate court has recently held that

> in a bad faith case, the primary test is whether the insurer withheld payment of an insured's claim unreasonably and in bad faith. Where benefits are withheld for proper cause, there is no breach of the implied covenant. . . . A court can conclude as a matter of law that an insurer's denial of a claim is not unreasonable, so long as there existed a genuine issue as to the insurer's liability. The "genuine dispute" doctrine may be applied where the insurer denies a claim based on the opinions of experts.

**[*83]** *Fraley v. Allstate Ins. Co.*, 81 Cal.App.4th 1282, 1292, 97 Cal.Rptr.2d 386, 391 (2000) (internal citations and quotation marks omitted). Further, the existence of a significant disagreement between the insurer's expert and the insured's expert does not render **[**26]** the insurer's decision to rely on its expert's opinion unreasonable. *See id.* at 1292-93. Provident relied on Dr. DeMasi's expert opinion, which was supported by medical testing, and not contradicted by any conclusive evidence. In light of the information available to Provident at the time it made its decision, it was not unreasonable for Provident to deny her claim and discontinue payments to her. Harris did not produce any evidence that would create a genuine issue of material fact as to the reasonableness of Provident's decision, and Provident therefore was entitled to summary judgment on this claim even under California law. Because this claim was properly dismissed under either New York law or California law, we affirm the district court's dismissal of this claim.

IV. *Provident's Counterclaim for Rescission*

Provident contends that the district court erred in dismissing its counterclaim for rescission of the insurance contract. Provident asserts that Harris withheld material information from it, specifically, the results of her tests by Johns Hopkins and the Mayo Clinic. Harris does not dispute that she failed to disclose these reports. However, Provident **[**27]** is not entitled to rescission as a result of Harris' failure to disclose, for several reasons.

First, as Harris correctly asserts in her brief, Provident had already made its decision to deny benefits to Harris before Harris had access to the reports from either Johns Hopkins or the Mayo Clinic, and therefore any nondisclosure of these reports by Harris could not possibly have affected Provident's decision. Provident made its decision to deny Harris benefits in October 1998. Harris was initially evaluated at Johns Hopkins on October 15, 1998; she received the report of this evaluation in January 1999. Harris returned to Johns Hopkins for additional testing in May 1999. Harris visited the Mayo Clinic only once, in June 1999.

Second, on October 15, 1998, Dr. Adkinson of Johns Hopkins orally advised Harris that he believed it would be safe for her to return to work. Harris received notice on October 24, 1998 that Provident had decided to deny benefits to her. The record shows that Provident employees met on October 13, 1998 to discuss and possibly make a decision on Harris' claim. Thus, it is likely that Provident made its decision before Harris even visited Johns Hopkins.

Third, the **[**28]** reports from Johns Hopkins and the Mayo Clinic support Provident's decision to deny benefits. Provident does not contend that it would have made a different decision had it been aware of the results of these evaluations. Therefore, any nondisclosure by Harris was immaterial because it did not affect the outcome of Provident's decision.

Provident contends that Harris had a continuing obligation to disclose information relevant to her condition, even after her claim for benefits had been denied. In support of its position, Provident cites a series of cases stating that nondisclosure is grounds for rescission of an insurance contract. The cases relied on by Provident (and by Harris) involve misrepresentations made in applications for insurance coverage, as opposed to demands for benefits under an existing policy, but the rationale applied in those cases applies equally here: if the misrepresentation does not affect the outcome of the insurer's decision, it is not material. *See Jackson v. Travelers Ins.* **[*84]** *Co.*, 113 F.3d 367, 371 (2d Cir. 1997) (upholding summary judgment in favor of insurer where insured misrepresented material facts related to his medical history on his **[**29]** application for insurance, and holding that "if a fact is material to the risk, the insurer may avoid liability under a policy if that fact was misrepresented in an application for that policy"); *Fine v.*

*Bellefonte Underwriters Ins. Co.*, 725 F.2d 179, 184 (2d Cir. 1984) ("False sworn answers are material if they might have affected the attitude and action of the insurer."). Once the decision had been made to deny benefits to Harris, any failure by Harris to disclose new information regarding her condition was immaterial, because it could not possibly affect Provident's decision. Accordingly, the district court did not err in dismissing Provident's counterclaim.

CONCLUSION

We conclude that genuine issues of material fact exist as to whether Harris is permanently disabled from working as an anesthesiologist. Therefore, we vacate the district court's grant of summary judgment as to the plaintiff's breach of contract claim and remand this case for further proceedings as to that claim only. We affirm the district court's dismissal of the plaintiff's claim for breach of the implied covenant of good faith and fair dealing, as well as the dismissal of Provident's counterclaim.

**[**30]** Each party shall bear its own costs on this appeal.

# TAB 12

2014 SCC 71, 2014 CSC 71
Supreme Court of Canada

Bhasin v. Hrynew

2014 CarswellAlta 2046, 2014 CarswellAlta 2047, 2014 SCC 71, 2014 CSC 71, [2014] 11 W.W.R. 641, [2014] 3 S.C.R. 494, [2014] A.W.L.D. 4738, [2014] A.W.L.D. 4740, [2014] A.W.L.D. 4828, [2014] A.W.L.D. 4829, [2014] S.C.J. No. 71, 20 C.C.E.L. (4th) 1, 245 A.C.W.S. (3d) 832, 27 B.L.R. (5th) 1, 379 D.L.R. (4th) 385, 464 N.R. 254, 584 A.R. 6, 623 W.A.C. 6, J.E. 2014-1992

# Harish Bhasin, carrying on business as Bhasin & Associates, Appellant and Larry Hrynew and Heritage Education Funds Inc. (formerly known as Allianz Education Funds Inc., formerly known as Canadian American Financial Corp. (Canada) Limited), Respondents

McLachlin C.J.C., LeBel, Abella, Rothstein, Cromwell, Karakatsanis, Wagner JJ.

Heard: February 12, 2014
Judgment: November 13, 2014
Docket: 35380

Proceedings: reversing in part *Bhasin v. Hrynew* (2013), [2013] 11 W.W.R. 459, 84 Alta. L.R. (5th) 68, 12 B.L.R. (5th) 175, 567 W.A.C. 28, 544 A.R. 28, 2013 CarswellAlta 822, 2013 ABCA 98, 362 D.L.R. (4th) 18, Jean Côté J.A., Marina Paperny J.A., R. Paul Belzil J. (Alta. C.A.); reversing *Bhasin v. Hrynew* (2011), [2012] 9 W.W.R. 728, 96 B.L.R. (4th) 73, 2011 ABQB 637, 2011 CarswellAlta 1905, A.B. Moen J. (Alta. Q.B.)

Counsel: Neil Finkelstein, Brandon Kain, John McCamus, Stephen Moreau, for Appellant
Eli S. Lederman, Jon Laxer, Constanza Pauchulo, for Respondents

Subject: Civil Practice and Procedure; Contracts; Torts

## Headnote

**Contracts --- Performance or breach — Obligation to perform — Sufficiency of performance — Duty to perform in good faith**

C Corp. was in business of selling education savings plans to investors, through contracts with enrolment directors — B and H were enrolment directors, and were competitors — Enrolment director's agreement governed relationship between C Corp. and B — C Corp. appointed H as provincial trading officer (PTO) to review its enrolment directors for compliance with securities laws after Alberta Securities Commission raised concerns about compliance issues among C Corp.'s enrolment directors — C Corp. outlined its plans to Commission, and they included B working for H's agency — When B refused to allow H to audit his records, C Corp. threatened to terminate agreement — C Corp. gave notice of non renewal under agreement — At expiry of contract term, B lost value in his business in his assembled workforce — Majority of B's sales agents were successfully solicited by H's agency — B's action against C Corp. and H was allowed — Trial judge found C Corp. was in breach of implied term of good faith, H had intentionally induced breach of contract, and both C Corp. and H were liable for civil conspiracy — Court of Appeal allowed appeal and dismissed B's action — B appealed — Appeal allowed in part — Appeal with respect to C Corp. was allowed, and appeal with respect to H was dismissed — Trial judge did not make reversible error by adjudicating issue of good faith — C Corp. breached agreement when it failed to act honestly with B in exercising non renewal clause — Trial judge's findings amply supported conclusion that C Corp.

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acted dishonestly with B throughout period leading up to its exercise of non renewal clause, both with respect to its own intentions and with respect to H's role as PTO — Claims against H were rightly dismissed — Court of Appeal was correct in finding that there could be no liability for inducing breach of contract or unlawful means conspiracy.

**Contracts --- Remedies for breach — Damages — Miscellaneous**

C Corp. was in business of selling education savings plans to investors, through contracts with enrolment directors — B and H were enrolment directors, and were competitors — Enrolment director's agreement governed relationship between C Corp. and B — C Corp. appointed H as provincial trading officer to review its enrolment directors for compliance with securities laws after the Alberta Securities Commission raised concerns about compliance issues among C Corp.s enrolment directors — C Corp. outlined its plans to Commission and they included B working for H's agency — When B refused to allow H to audit his records, C Corp. threatened to terminate agreement — C Corp. gave notice of non renewal under agreement — At expiry of contract term, B lost value in his business in his assembled workforce — Majority of B's sales agents were successfully solicited by H's agency — B's action against C Corp. and H was allowed — Trial judge found C Corp. was in breach of implied term of good faith, H had intentionally induced breach of contract, and both C Corp. and H were liable for civil conspiracy — Court of Appeal allowed appeal and dismissed B's action — B appealed — Appeal allowed in part — Appeal with respect to C Corp. was allowed, and appeal with respect to H was dismissed — Trial judge's assessment of damages was varied to $87,000 plus interest — C Corp. was liable for damages calculated on basis of what B's economic position would have been had C Corp. fulfilled its duty — While trial judge did not assess damages on that basis, given different findings in relation to liability, trial judge made findings that permitted current Court to do so — These findings permitted damages to be assessed on basis that if C Corp. had performed contract honestly, B would have been able to retain value of his business rather than see it, in effect, expropriated and turned over to H — It was clear from findings of trial judge and from record that value of business around time of non renewal was $87,000.

**Torts --- Inducing breach of contract — Elements of tort**

C Corp. was in business of selling education savings plans to investors, through contracts with enrolment directors — B and H were enrolment directors, and were competitors — Enrolment director's agreement governed relationship between C Corp. and B — C Corp. appointed H as provincial trading officer (PTO) to review its enrolment directors for compliance with securities laws after Alberta Securities Commission raised concerns about compliance issues among C Corp.'s enrolment directors — C Corp. outlined its plans to Commission, and they included B working for H's agency — When B refused to allow H to audit his records, C Corp. threatened to terminate agreement — C Corp. gave notice of non renewal under agreement — At expiry of contract term, B lost value in his business in his assembled workforce — Majority of B's sales agents were successfully solicited by H's agency — B's action against C Corp. and H was allowed — Trial judge found C Corp. was in breach of implied term of good faith, H had intentionally induced breach of contract, and both C Corp. and H were liable for civil conspiracy — Court of Appeal allowed appeal and dismissed B's action — B appealed — Appeal allowed in part — Appeal with respect to C Corp. was allowed, and appeal with respect to H was dismissed — Trial judge did not make reversible error by adjudicating issue of good faith — C Corp. breached agreement when it failed to act honestly with B in exercising non renewal clause — Trial judge's findings amply supported conclusion that C Corp. acted dishonestly with B throughout period leading up to its exercise of non renewal clause, both with respect to its own intentions and with respect to H's role as PTO — Claims against H were rightly dismissed — Court of Appeal was correct in finding that there could be no liability for inducing breach of contract or unlawful means conspiracy.

**Torts --- Conspiracy — Nature and elements of tort — Miscellaneous**

C Corp. was in business of selling education savings plans to investors, through contracts with enrolment directors — B and H were enrolment directors, and were competitors — Enrolment director's agreement governed relationship between C Corp. and B — C Corp. appointed H as provincial trading officer (PTO) to review its enrolment directors for compliance with securities laws after Alberta Securities Commission raised concerns about compliance issues among C Corp.'s enrolment directors — C Corp. outlined its plans to Commission, and they included B working for H's agency — When B refused to allow H to audit his records, C Corp. threatened to terminate agreement — C Corp. gave notice of non renewal under agreement — At expiry of contract term, B lost value in his business in his assembled workforce — Majority of B's sales agents were successfully solicited by H's agency — B's action against C Corp. and H was allowed — Trial judge found C Corp. was in breach of implied term of good faith, H had intentionally induced breach of contract, and both C Corp. and H were liable for civil conspiracy — Court of Appeal allowed appeal and dismissed B's action — B appealed — Appeal allowed in part — Appeal with respect to C Corp. was allowed, and appeal with respect to H was dismissed —

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Trial judge did not make reversible error by adjudicating issue of good faith — C Corp. breached agreement when it failed to act honestly with B in exercising non renewal clause — Trial judge's findings amply supported conclusion that C Corp. acted dishonestly with B throughout period leading up to its exercise of non renewal clause, both with respect to its own intentions and with respect to H's role as PTO — Claims against H were rightly dismissed — Court of Appeal was correct in finding that there could be no liability for inducing breach of contract or unlawful means conspiracy.

**Contrats --- Exécution ou défaut d'exécution — Obligation d'exécuter — Exécution acceptable — Obligation d'exécuter de bonne foi**

Société C oeuvrait dans le domaine de la vente aux investisseurs des régimes enregistrés d'épargne-études par l'intermédiaire de directeurs de souscriptions — B et H étaient des directeurs de souscription et étaient en concurrence l'un contre l'autre — Relation entre la société C et B était régie par une entente relative au directeur des souscriptions — Société C a nommé H au poste d'agent commercial provincial (ACP), chargé de la vérification des activités de ses directeurs des souscriptions au plan du respect de la législation en matière de valeurs mobilières après que la Commission des valeurs mobilières de l'Alberta a soulevé des questions au sujet de la conformité des activités des directeurs des souscriptions de la société C — Société C a présenté ses plans à la Commission selon lesquels il était prévu que B travaillerait pour l'agence de H — Comme B refusait toujours de permettre à H de vérifier ses registres, la société C a menacé de résilier l'entente — Société C a donné à B un préavis de non-renouvellement conformément à l'entente — À l'échéance du contrat, l'entreprise de B a perdu son effectif, qui constituait la valeur de son entreprise — Majorité de ses représentants des ventes ont été recrutés par l'agence de H — Action déposée par B à l'encontre de la société C et H a été accueillie — Juge de première instance a conclu que la société C avait violé la condition implicite d'agir de bonne foi, que H avait intentionnellement incité à la rupture de contrat et que la société C et H avaient engagé leur responsabilité pour complot civil — Cour d'appel a accueilli l'appel et a rejeté l'action de B — B a formé un pourvoi — Pourvoi accueilli en partie — Pourvoi relatif à la société C accueilli; pourvoi relatif à H rejeté — Juge de première instance n'a pas commis d'erreur donnant lieu à révision lorsqu'elle a tranché la question de la bonne foi — Société C a violé le contrat lorsqu'elle n'a pas agi honnêtement envers B en recourant à la clause de non-renouvellement — Motifs de la juge étayaient amplement la conclusion que la société C n'a pas agi honnêtement envers B pendant la période précédant le recours à la clause de non-renouvellement, en raison de ses propres intentions et du rôle joué par H en sa qualité d'ACP — Demandes contre H ont été à juste titre rejetées — Cour d'appel a eu raison de ne retenir aucune responsabilité pour un délit d'incitation à rupture de contrat ou de complot prévoyant le recours à des moyens illégaux.

**Contrats --- Réparation du défaut — Dommages-intérêts — Divers**

Société C oeuvrait dans le domaine de la vente aux investisseurs des régimes enregistrés d'épargne-études par l'intermédiaire de directeurs de souscriptions — B et H étaient des directeurs de souscription et étaient en concurrence l'un contre l'autre — Relation entre la société C et B était régie par une entente relative au directeur des souscriptions — Société C a nommé H au poste d'agent commercial provincial, chargé de la vérification des activités de ses directeurs des souscriptions au plan du respect de la législation en matière de valeurs mobilières après que la Commission des valeurs mobilières de l'Alberta a soulevé des questions au sujet de la conformité des activités des directeurs des souscriptions de la société C — Société C a présenté ses plans à la Commission selon lesquels il était prévu que B travaillerait pour l'agence de H — Comme B refusait toujours de permettre à H de vérifier ses registres, la société C a menacé de résilier l'entente — Société C a donné à B un préavis de non-renouvellement conformément à l'entente — À l'échéance du contrat, l'entreprise de B a perdu son effectif, qui constituait la valeur de son entreprise — Majorité de ses représentants des ventes ont été recrutés par l'agence de H — Action déposée par B à l'encontre de la société C et H a été accueillie — Juge de première instance a conclu que la société C avait violé la condition implicite d'agir de bonne foi, que H avait intentionnellement incité à la rupture de contrat et que la société C et H avaient engagé leur responsabilité pour complot civil — Cour d'appel a accueilli l'appel et a rejeté l'action de B — B a formé un pourvoi — Pourvoi accueilli en partie — Pourvoi relatif à la société C accueilli; pourvoi relatif à H rejeté — Appréciation des dommages-intérêts faite par la juge de première instance a été modifiée et fixée à 87 000 $ plus l'intérêt — Société C était responsable de dommages-intérêts calculés en fonction de la situation financière dans laquelle se serait trouvé B si la société C s'était acquittée de son obligation — Bien que la juge de première instance n'ait pas évalué le montant des dommages-intérêts en fonction de ce critère, compte tenu des conclusions différentes qu'elle a tirées en ce qui a trait à la responsabilité, elle a tiré des conclusions qui permettaient à cette Cour de le faire — Ces conclusions permettaient une évaluation des dommages-intérêts fondée sur le fait que, si la société C avait exécuté honnêtement le contrat, B aurait été en mesure de conserver la valeur de son entreprise plutôt que de s'en voir dépossédé au profit de H — Il ressortait clairement des conclusions de la juge de première instance ainsi que du dossier que la valeur de l'entreprise vers la date du

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non-renouvellement était de 87 000 $.

**Délits civils --- Incitation à violer un contrat — Éléments constitutifs du délit**

Société C oeuvrait dans le domaine de la vente aux investisseurs des régimes enregistrés d'épargne-études par l'intermédiaire de directeurs de souscriptions — B et H étaient des directeurs de souscription et étaient en concurrence l'un contre l'autre — Relation entre la société C et B était régie par une entente relative au directeur des souscriptions — Société C a nommé H au poste d'agent commercial provincial (ACP), chargé de la vérification des activités de ses directeurs des souscriptions au plan du respect de la législation en matière de valeurs mobilières après que la Commission des valeurs mobilières de l'Alberta a soulevé des questions au sujet de la conformité des activités des directeurs des souscriptions de la société C — Société C a présenté ses plans à la Commission selon lesquels il était prévu que B travaillerait pour l'agence de H — Comme B refusait toujours de permettre à H de vérifier ses registres, la société C a menacé de résilier l'entente — Société C a donné à B un préavis de non-renouvellement conformément à l'entente — À l'échéance du contrat, l'entreprise de B a perdu son effectif, qui constituait la valeur de son entreprise — Majorité de ses représentants des ventes ont été recrutés par l'agence de H — Action déposée par B à l'encontre de la société C et H a été accueillie — Juge de première instance a conclu que la société C avait violé la condition implicite d'agir de bonne foi, que H avait intentionnellement incité à la rupture de contrat et que la société C et H avaient engagé leur responsabilité pour complot civil — Cour d'appel a accueilli l'appel et a rejeté l'action de B — B a formé un pourvoi — Pourvoi accueilli en partie — Pourvoi relatif à la société C accueilli; pourvoi relatif à H rejeté — Juge de première instance n'a pas commis d'erreur donnant lieu à révision lorsqu'elle a tranché la question de la bonne foi — Société C a violé le contrat lorsqu'elle n'a pas agi honnêtement envers B en recourant à la clause de non-renouvellement — Motifs de la juge étayaient amplement la conclusion que la société C n'a pas agi honnêtement envers B pendant la période précédant le recours à la clause de non-renouvellement, en raison de ses propres intentions et du rôle joué par H en sa qualité d'ACP — Demandes contre H ont été à juste titre rejetées — Cour d'appel a eu raison de ne retenir aucune responsabilité pour un délit d'incitation à rupture de contrat ou de complot prévoyant le recours à des moyens illégaux.

**Délits civils --- complot — Nature et éléments constitutifs du délit — Divers**

Société C oeuvrait dans le domaine de la vente aux investisseurs des régimes enregistrés d'épargne-études par l'intermédiaire de directeurs de souscriptions — B et H étaient des directeurs de souscription et étaient en concurrence l'un contre l'autre — Relation entre la société C et B était régie par une entente relative au directeur des souscriptions — Société C a nommé H au poste d'agent commercial provincial (ACP), chargé de la vérification des activités de ses directeurs des souscriptions au plan du respect de la législation en matière de valeurs mobilières après que la Commission des valeurs mobilières de l'Alberta a soulevé des questions au sujet de la conformité des activités des directeurs des souscriptions de la société C — Société C a présenté ses plans à la Commission selon lesquels il était prévu que B travaillerait pour l'agence de H — Comme B refusait toujours de permettre à H de vérifier ses registres, la société C a menacé de résilier l'entente — Société C a donné à B un préavis de non-renouvellement conformément à l'entente — À l'échéance du contrat, l'entreprise de B a perdu son effectif, qui constituait la valeur de son entreprise — Majorité de ses représentants des ventes ont été recrutés par l'agence de H — Action déposée par B à l'encontre de la société C et H a été accueillie — Juge de première instance a conclu que la société C avait violé la condition implicite d'agir de bonne foi, que H avait intentionnellement incité à la rupture de contrat et que la société C et H avaient engagé leur responsabilité pour complot civil — Cour d'appel a accueilli l'appel et a rejeté l'action de B — B a formé un pourvoi — Pourvoi accueilli en partie — Pourvoi relatif à la société C accueilli; pourvoi relatif à H rejeté — Juge de première instance n'a pas commis d'erreur donnant lieu à révision lorsqu'elle a tranché la question de la bonne foi — Société C a violé le contrat lorsqu'elle n'a pas agi honnêtement envers B en recourant à la clause de non-renouvellement — Motifs de la juge étayaient amplement la conclusion que la société C n'a pas agi honnêtement envers B pendant la période précédant le recours à la clause de non-renouvellement, en raison de ses propres intentions et du rôle joué par H en sa qualité d'ACP — Demandes contre H ont été à juste titre rejetées — Cour d'appel a eu raison de ne retenir aucune responsabilité pour un délit d'incitation à rupture de contrat ou de complot prévoyant le recours à des moyens illégaux.

C Corp. was in the business of selling education savings plans to investors, through contracts with enrolment directors. B and H were enrolment directors, and were competitors. An enrolment director's agreement governed the relationship between C Corp. and B. C Corp. appointed H as the provincial trading officer (PTO) to review its enrolment directors for compliance with securities laws after the Alberta Securities Commission raised concerns about compliance issues among C Corp.'s enrolment directors. C Corp. outlined its plans to the Commission, and they included B working for H's agency. When B refused to allow H to audit his records, C Corp. threatened to terminate the agreement. C Corp. gave notice of non

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renewal under the agreement. At the expiry of the contract term, B lost value in his business in his assembled workforce. The majority of B's sales agents were successfully solicited by H's agency.

B's action against C Corp. and H was allowed. The trial judge found C Corp. was in breach of the implied term of good faith, H had intentionally induced breach of contract, and both C Corp. and H were liable for civil conspiracy. The Court of Appeal allowed the appeal and dismissed B's action. B appealed.

**Held:** The appeal was allowed in part.

Per Cromwell J. (McLachlin C.J.C. and LeBel, Abella, Rothstein, Karakatsanis and Wagner JJ. concurring): The appeal with respect to C Corp. was allowed, and the appeal with respect to H was dismissed. The trial judge's assessment of damages was varied to $87,000 plus interest. The objection to C Corp.'s conduct did not fit within any of the existing situations or relationships in which duties of good faith have been found to exist. It is appropriate to recognize a new common law duty that applies to all contracts as a manifestation of the general organizing principle of good faith, namely a duty of honest performance, which requires the parties to be honest with each other in relation to the performance of their contractual obligations. Under this new general duty of honesty in contractual performance, parties must not lie or otherwise knowingly mislead each other about matters directly linked to the performance of the contract.

The trial judge did not make a reversible error by adjudicating the issue of good faith. C Corp. breached the agreement when it failed to act honestly with B in exercising the non renewal clause. The trial judge's findings amply supported the conclusion that C Corp. acted dishonestly with B throughout the period leading up to its exercise of the non renewal clause, both with respect to its own intentions and with respect to H's role as PTO. The caims against H were rightly dismissed. The Court of Appeal was correct in finding that there could be no liability for inducing breach of contract or unlawful means conspiracy.

C Corp. was liable for damages calculated on the basis of what B's economic position would have been had C Corp. fulfilled its duty. While the trial judge did not assess damages on that basis, given the different findings in relation to liability, the trial judge made findings that permitted the current Court to do so. These findings permitted damages to be assessed on the basis that if C Corp. had performed the contract honestly, B would have been able to retain the value of his business rather than see it, in effect, expropriated and turned over to H. It was clear from the findings of the trial judge and from the record that the value of the business around the time of non renewal was $87,000.

La société C oeuvrait dans le domaine de la vente aux investisseurs des régimes enregistrés d'épargne-études par l'intermédiaire de directeurs de souscriptions. B et H étaient des directeurs de souscription et étaient en concurrence l'un contre l'autre. La relation entre la société C et B était régie par une entente relative au directeur des souscriptions. La société C a nommé H au poste d'agent commercial provincial (ACP), chargé de la vérification des activités de ses directeurs des souscriptions au plan du respect de la législation en matière de valeurs mobilières après que la Commission des valeurs mobilières de l'Alberta a soulevé des questions au sujet de la conformité des activités des directeurs des souscriptions de la société C. La société C a présenté ses plans à la Commission selon lesquels il était prévu que B travaillerait pour l'agence de H. Comme B refusait toujours de permettre à H de vérifier ses registres, la société C a menacé de résilier l'entente. La société C a donné à B un préavis de non-renouvellement conformément à l'entente. À l'échéance du contrat, l'entreprise de B a perdu son effectif, qui constituait la valeur de son entreprise. La majorité de ses représentants des ventes ont été recrutés par l'agence de H.

L'action déposée par B à l'encontre de la société C et H a été accueillie. La juge de première instance a conclu que la société C avait violé la condition implicite d'agir de bonne foi, que H avait intentionnellement incité à la rupture de contrat et que la société C et H avaient engagé leur responsabilité pour complot civil. La Cour d'appel a accueilli l'appel et a rejeté l'action de B. B a formé un pourvoi.

**Arrêt:** Le pourvoi a été accueilli en partie.

Cromwell, J. (McLachlin, J.C.C., LeBel, Abella, Rothstein, Karakatsanis, Wagner, JJ., souscrivant à son opinion) : Le pourvoi relatif à la société C a été accueilli, le pourvoi relatif à H a été rejeté. L'appréciation des dommages-intérêts faite par la juge de première instance a été modifiée et fixée à 87 000 $ plus l'intérêt. Le reproche à l'égard de la conduite de la société C ne cadrait dans aucune des situations ou des relations à l'égard desquelles les obligations de bonne foi ont trouvé application. Il convient de reconnaître une nouvelle obligation en common law qui s'applique à tous les contrats en tant

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que manifestation du principe directeur général de bonne foi, soit une obligation d'exécution honnête qui oblige les parties à faire preuve d'honnêteté l'une envers l'autre dans le cadre de l'exécution de leurs obligations contractuelles. En vertu de cette nouvelle obligation générale d'honnêteté applicable à l'exécution des contrats, les parties ne doivent pas se mentir ni autrement s'induire intentionnellement en erreur au sujet de questions directement liées à l'exécution du contrat.

La juge de première instance n'a pas commis d'erreur donnant lieu à révision lorsqu'elle a tranché la question de la bonne foi. La société C a violé le contrat lorsqu'elle n'a pas agi honnêtement envers B en recourant à la clause de non-renouvellement. Les motifs de la juge étayaient amplement la conclusion que la société C n'a pas agi honnêtement envers B pendant la période précédant le recours à la clause de non-renouvellement, en raison de ses propres intentions et du rôle joué par H en sa qualité d'ACP. Les demandes contre H ont été à juste titre rejetées. La Cour d'appel a eu raison de ne retenir aucune responsabilité pour un délit d'incitation à rupture de contrat ou de complot prévoyant le recours à des moyens illégaux.

La société C était responsable de dommages-intérêts calculés en fonction de la situation financière dans laquelle se serait trouvé B si la société C s'était acquittée de son obligation. Bien que la juge de première instance n'ait pas évalué le montant des dommages-intérêts en fonction de ce critère, compte tenu des conclusions différentes qu'elle a tirées en ce qui a trait à la responsabilité, elle a tiré des conclusions qui permettaient à cette Cour de le faire. Ces conclusions permettaient une évaluation des dommages-intérêts fondée sur le fait que, si la société C avait exécuté honnêtement le contrat, B aurait été en mesure de conserver la valeur de son entreprise plutôt que de s'en voir dépossédé au profit de H. Il ressortait clairement des conclusions de la juge de première instance ainsi que du dossier que la valeur de l'entreprise vers la date du non-renouvellement était de 87 000 $.

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*Herbert v. Mercantile Fire Insurance Co.* (1878), 43 U.C.Q.B. 384, 1878 CarswellOnt 200 (Ont. Q.B.) — referred to

*Hill v. Church of Scientology of Toronto* (1995), 25 C.C.L.T. (2d) 89, 184 N.R. 1, (sub nom. *Manning v. Hill)* 126 D.L.R. (4th) 129, 24 O.R. (3d) 865 (note), 84 O.A.C. 1, [1995] 2 S.C.R. 1130, 1995 CarswellOnt 396, 1995 CarswellOnt 534, (sub nom. *Hill v. Church of Scientology)* 30 C.R.R. (2d) 189, 24 O.R. (3d) 865 (S.C.C.) — referred to

*Interfoto Library Ltd. v. Stiletto Visual Programmes Ltd.* (1987), [1987] EWCA Civ 6, [1989] 1 Q.B. 433 (Eng. C.A.) — considered

*J.H. Westerbeke Corp. v. Onan Corp.* (1984), 580 F. Supp. 1173 (U.S. Dist. Ct. D. Mass.) — referred to

*Keays v. Honda Canada Inc.* (2008), 2008 SCC 39, (sub nom. *Honda Canada Inc. v. Keays)* 2008 C.L.L.C. 230-025, 376 N.R. 196, 294 D.L.R. (4th) 577, (sub nom. *Honda Canada Inc. v. Keays)* [2008] 2 S.C.R. 362, 92 O.R. (3d) 479 (note), (sub nom. *Honda Canada Inc. v. Keays)* 63 C.H.R.R. D/247, 66 C.C.E.L. (3d) 159, 2008 CarswellOnt 3743, 2008 CarswellOnt 3744, 239 O.A.C. 299 (S.C.C.) — considered

*Kirke La Shelle Co. v. Armstrong Co.* (1933), 263 N.Y. 79 (U.S. N.Y. Ct. App.) — referred to

*L. Schuler A.G. v. Wickman Machine Tool Sales Ltd.* (1973), [1973] 2 All E.R. 39, (sub nom. *Wickman Machine Tool Sales Ltd. v. L.Schuler A.G.)* [1974] A.C. 235 (U.K. H.L.) — considered

*LeMesurier v. Andrus* (1986), 38 R.P.R. 183, 54 O.R. (2d) 1, 25 D.L.R. (4th) 424, 12 O.A.C. 299, 1986 CarswellOnt 670 (Ont. C.A.) — considered

*London Drugs Ltd. v. Kuehne & Nagel International Ltd.* (1992), [1993] 1 W.W.R. 1, [1992] 3 S.C.R. 299, (sub nom. *London Drugs Ltd. v. Brassart)* 143 N.R. 1, 73 B.C.L.R. (2d) 1, 43 C.C.E.L. 1, 13 C.C.L.T. (2d) 1, (sub nom. *London Drugs Ltd. v. Brassart)* 18 B.C.A.C. 1, (sub nom. *London Drugs Ltd. v. Brassart)* 31 W.A.C. 1, 97 D.L.R. (4th) 261, 1992 CarswellBC 913, 1992 CarswellBC 315 (S.C.C.) — referred to

*M.J.B. Enterprises Ltd. v. Defence Construction (1951) Ltd.* (1999), 170 D.L.R. (4th) 577, 49 B.L.R. (2d) 1, 237 N.R. 334, 44 C.L.R. (2d) 163, [1999] 1 S.C.R. 619, 232 A.R. 360, 195 W.A.C. 360, 1999 CarswellAlta 301, 1999 CarswellAlta 302, 2 T.C.L.R. 235, 69 Alta. L.R. (3d) 341, [1999] 7 W.W.R. 681, 3 M.P.L.R. (3d) 165 (S.C.C.) — referred to

*Machtinger v. HOJ Industries Ltd.* (1992), 40 C.C.E.L. 1, (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, [1992] 1 S.C.R. 986, 1992 CarswellOnt 892, 7 O.R. (3d) 480 (note), 7 O.R. (3d) 480, 1992 CarswellOnt 989 (S.C.C.) — referred to

*Maracle v. Travelers Indemnity Co. of Canada* (1991), [1991] I.L.R. 1-2728, 125 N.R. 294, 80 D.L.R. (4th) 652, 47 O.A.C. 333, (sub nom. *Travellers Indemnity Co. of Canada v. Maracle)* [1991] 2 S.C.R. 50, 50 C.P.C. (2d) 213, 3 C.C.L.I. (2d) 186, 3 O.R. (3d) 510, 1991 CarswellOnt 450, 3 O.R. (3d) 510 (note), 1991 CarswellOnt 1019 (S.C.C.) — referred to

*Martel Building Ltd. v. R.* (2000), 2000 SCC 60, (sub nom. *Martel Building Ltd. v. Canada)* [2000] 2 S.C.R. 860, 36 R.P.R. (3d) 175, (sub nom. *Martel Building Ltd. v. Canada)* 193 D.L.R. (4th) 1, 2000 CarswellNat 2678, 2000 CarswellNat 2679, 2000 CSC 60, 3 C.C.L.T. (3d) 1, 5 C.L.R. (3d) 161, (sub nom. *Martel Building Ltd. v. Canada)* 262 N.R. 285, 186 F.T.R. 231 (note) (S.C.C.) — referred to

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*McDonald's Restaurants of Canada Ltd. v. British Columbia* (1997), 7 R.P.R. (3d) 202, 1997 CarswellBC 481, 29 B.C.L.R. (3d) 303, 88 B.C.A.C. 33, 144 W.A.C. 33, [1997] 4 W.W.R. 229 (B.C. C.A.) — referred to

*Mellish v. Motteux* (1792), 170 E.R. 113, Peake 156 (Eng. K.B.) — referred to

*Mesa Operating Ltd. Partnership v. Amoco Canada Resources Ltd.* (1994), 19 Alta. L.R. (3d) 38, 149 A.R. 187, 63 W.A.C. 187, 13 B.L.R. (2d) 310, 1994 CarswellAlta 89 (Alta. C.A.) — considered

*Mid Essex Hospital Services NHS Trust v. Compass Group UK and Ireland Ltd.* (2013), [2013] EWCA Civ 200 (Eng. C.A.) — considered

*Mills v. Mills* (1938), 60 C.L.R. 150, 11 A.L.J. 527 (Australia H.C.) — considered

*Mitsui & Co. (Canada) Ltd. v. Royal Bank* (1995), 32 C.B.R. (3d) 1, 1995 CarswellNS 59, 1995 CarswellNS 84, 180 N.R. 161, 123 D.L.R. (4th) 449, [1995] 2 S.C.R. 187, 142 N.S.R. (2d) 1, 407 A.P.R. 1 (S.C.C.) — considered

*Parna v. G. & S. Properties Ltd.* (1970), [1971] S.C.R. 306, 1970 CarswellOnt 208, 1970 CarswellOnt 208F, 15 D.L.R. (3d) 336 (S.C.C.) — referred to

*Peel (Regional Municipality) v. Canada* (1992), (sub nom. *Peel (Regional Municipality) v. Ontario)* 144 N.R. 1, 1992 CarswellNat 15, 55 F.T.R. 277 (note), 12 M.P.L.R. (2d) 229, 98 D.L.R. (4th) 140, [1992] 3 S.C.R. 762, 59 O.A.C. 81, 1992 CarswellNat 659 (S.C.C.) — followed

*Pepsi-Cola Canada Beverages (West) Ltd. v. R.W.D.S.U., Local 558* (2002), (sub nom. *R.W.D.S.U., Local 558 v. Pepsi-Cola Canada Beverages (West) Ltd.)* 2002 SCC 8, 2002 CarswellSask 22, 2002 CarswellSask 23, 217 Sask. R. 22, 265 W.A.C. 22, (sub nom. *R.W.D.S.U., Local 558 v. Pepsi-Cola Canada Beverages (West) Ltd.)* [2002] 1 S.C.R. 156, 2002 C.L.L.C. 220-008, 280 N.R. 333, [2002] 4 W.W.R. 205, 208 D.L.R. (4th) 385, (sub nom. *R.W.D.S.U., Local 558 v. Pepsi-Cola Canada Beverages (West) Ltd.)* 90 C.R.R. (2d) 189, 78 C.L.R.B.R. (2d) 161, 2002 CSC 8 (S.C.C.) — referred to

*Pitney-Bowes Inc. v. Mestre* (1981), 517 F. Supp. 52 (U.S. Dist. Ct. S.D. Fla.) — referred to

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*R. v. Hart* (2014), 375 D.L.R. (4th) 1, 312 C.C.C. (3d) 250, 461 N.R. 1, 12 C.R. (7th) 221, 2014 SCC 52, 2014 CSC 52, 2014 CarswellNfld 215, 2014 CarswellNfld 216 (S.C.C.) — referred to

*R. v. Jones* (1994), 30 C.R. (4th) 1, 166 N.R. 321, 43 B.C.A.C. 241, 69 W.A.C. 241, 89 C.C.C. (3d) 353, [1994] 2 S.C.R. 229, 114 D.L.R. (4th) 645, 21 C.R.R. (2d) 286, 1994 CarswellBC 580, 1994 CarswellBC 1240 (S.C.C.) — referred to

*R. v. Salituro* (1991), 9 C.R. (4th) 324, 8 C.R.R. (2d) 173, 50 O.A.C. 125, [1991] 3 S.C.R. 654, 131 N.R. 161, 68 C.C.C. (3d) 289, 1991 CarswellOnt 1031, 1991 CarswellOnt 124 (S.C.C.) — considered

*Renard Constructions (ME) Pty. Ltd. v. Canada (Minister of Public Works)* (1992), 26 N.S.W.L.R. 234 (New South Wales C.A.) — considered

*Ryan v. Moore* (2005), 254 D.L.R. (4th) 1, 334 N.R. 355, [2005] 2 S.C.R. 53, 2005 CSC 38, 2005 SCC 38, 2005 CarswellNfld 157, 2005 CarswellNfld 158, 247 Nfld. & P.E.I.R. 286, 735 A.P.R. 286, 25 C.C.L.I. (4th) 1, 32 C.C.L.T. (3d) 1, [2005] R.R.A. 694, 18 E.T.R. (3d) 163 (S.C.C.) — referred to

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*Shell Oil Co. v. Marinello* (1972), 294 A.2d 253 (U.S. N.J. Sup. Ct.) — referred to

*Shell Oil Co. v. Marinello* (1973), 307 A.2d 598, 63 N.J. 402 (U.S. N.J. Sup. Ct.) — referred to

*Tercon Contractors Ltd. v. British Columbia (Minister of Transportation & Highways)* (2010), 397 N.R. 331, [2010] 1 S.C.R. 69, 281 B.C.A.C. 245, 475 W.A.C. 245, 315 D.L.R. (4th) 385, 2010 CarswellBC 296, 2010 CarswellBC 297, 2010 SCC 4, 86 C.L.R. (3d) 163, 65 B.L.R. (4th) 1, [2010] 3 W.W.R. 387, 100 B.C.L.R. (4th) 201 (S.C.C.) — referred to

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*United Roasters Inc. v. Colgate-Palmolive Co.* (1981), 649 F.2d 985 (U.S. C.A. 4th Cir.) — distinguished

*Wallace v. United Grain Growers Ltd.* (1997), 123 Man. R. (2d) 1, 159 W.A.C. 1, 152 D.L.R. (4th) 1, 1997 CarswellMan 455, 1997 CarswellMan 456, 219 N.R. 161, [1997] 3 S.C.R. 701, [1999] 4 W.W.R. 86, 36 C.C.E.L. (2d) 1, 3 C.B.R. (4th) 1, [1997] L.V.I. 2889-1, 97 C.L.L.C. 210-029 (S.C.C.) — considered

*Watkins v. Olafson* (1989), 50 C.C.L.T. 101, 1989 CarswellMan 333, [1989] 2 S.C.R. 750, [1989] 6 W.W.R. 481, 61 D.L.R. (4th) 577, 100 N.R. 161, 39 B.C.L.R. (2d) 294, 61 Man. R. (2d) 81, 1989 CarswellMan 1 (S.C.C.) — referred to

*Whiten v. Pilot Insurance Co.* (2002), 156 O.A.C. 201, 35 C.C.L.I. (3d) 1, [2002] 1 S.C.R. 595, 2002 SCC 18, 2002 CarswellOnt 537, 2002 CarswellOnt 538, 283 N.R. 1, 20 B.L.R. (3d) 165, [2002] I.L.R. I-4048, 209 D.L.R. (4th) 257, 58 O.R. (3d) 480 (note), 2002 CSC 18 (S.C.C.) — considered

*Yam Seng Pte Ltd. v. International Trade Corp Ltd.* (2013), [2013] EWHC 111, [2013] 1 All E.R. (Comm) 1321 (Eng. Q.B.) — considered

*702535 Ontario Inc. v. Non-Marine Underwriters, Lloyd's London, England* (2000), 2000 CarswellOnt 904, 107 O.T.C. 396, (sub nom. *702535 Ontario Inc. v. Non-Marine Underwriters, Lloyd's, London)* 130 O.A.C. 373, (sub nom. *702535 Ontario Inc. v. Lloyd's London, Non-Marine Underwriters)* 184 D.L.R. (4th) 687, (sub nom. *702535 Ontario Inc. v. Lloyd's London Non-Marine Underwriters)* [2000] I.L.R. I-3826 (Ont. C.A.) — referred to

**Statutes considered:**

*Code civil du Bas-Canada*, S. Prov. C. 1865, c. 41
en général — referred to

*Code civil du Québec*, L.Q. 1991, c. 64
en général — referred to

art. 6 — referred to

art. 7 — referred to

art. 1375 — referred to

*Franchises Act*, R.S.A. 2000, c. F-23
s. 7 — referred to

*Uniform Commercial Code*, 2012
Generally — referred to

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Aricle 1-201(b)(20) “Good faith” — considered

Aricle 1-302(b) — considered

Article 1-304 — considered

APPEAL by plaintiff from judgment reported at *Bhasin v. Hrynew* (2013), 2013 ABCA 98, 2013 CarswellAlta 822, 544 A.R. 28, 567 W.A.C. 28, 362 D.L.R. (4th) 18, 12 B.L.R. (5th) 175, 84 Alta. L.R. (5th) 68, [2013] 11 W.W.R. 459 (Alta. C.A.), allowing appeal from decision by trial judge allowing plaintiff's action for damages.

POURVOI formé par la partie demanderesse à l'encontre d'un jugement publié à *Bhasin v. Hrynew* (2013), 2013 ABCA 98, 2013 CarswellAlta 822, 544 A.R. 28, 567 W.A.C. 28, 362 D.L.R. (4th) 18, 12 B.L.R. (5th) 175, 84 Alta. L.R. (5th) 68, [2013] 11 W.W.R. 459 (Alta. C.A.), ayant accueilli l'appel interjeté à l'encontre de la décision de la juge de première instance d'accueillir l'action en dommages-intérêts de la partie demanderesse.

***Cromwell J.* (McLachlin C.J.C. and LeBel, Abella, Rothstein, Karakatsanis and Wagner JJ. concurring):**

## I. Introduction

1 The key issues on this appeal come down to two, straightforward questions: Does Canadian common law impose a duty on parties to perform their contractual obligations honestly? And, if so, did either of the respondents breach that duty? I would answer both questions in the affirmative. Finding that there is a duty to perform contracts honestly will make the law more certain, more just and more in tune with reasonable commercial expectations. It will also bring a measure of justice to the appellant, Mr. Bhasin, who was misled and lost the value of his business as a result.

## II. Facts and Judicial History

### *Overview and Issues*

2 The appellant, Mr. Bhasin, through his business Bhasin & Associates, was an enrollment director for Canadian American Financial Corp. ("Can-Am") beginning in 1989. The relationship between Mr. Bhasin and Can-Am soured in 1999 and ultimately Can-Am decided not to renew the dealership agreement with him. The litigation leading to this appeal ensued.

3 Can-Am markets education savings plans ("ESPs") to investors through retail dealers, known as enrollment directors, such as Mr. Bhasin. It pays the enrollment directors compensation and bonuses for selling ESPs. The enrollment directors are in effect small business owners and the success of their businesses depends on them building a sales force. It took Mr. Bhasin approximately 10 years to build his sales force, but his business thrived and Can-Am gave him numerous awards and prizes recognizing him as one of their top enrollment directors in Canada: 2011 ABQB 637, 544 A.R. 28 (Alta. Q.B.), at paras. 51, 238 and 474.

4 An enrollment director's agreement that took effect in 1998 governed the relationship between Can-Am and Mr. Bhasin. (That Agreement replaced a previous agreement of an indefinite term that had governed their relationship since the outset in

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1989.) The Agreement was a commercial dealership agreement, not a franchise agreement. There was no franchise fee and it was not covered by the statutory duty of fair dealing such as that provided for in s. 7 of the *Franchises Act*, R.S.A. 2000, c. F-23.

5 That said, there were some features of the 1998 Agreement that are similar to provisions typically found in franchise agreements. Mr. Bhasin was obliged to sell Can-Am investment products exclusively and owed it a fiduciary duty. Can-Am owned the client lists, was responsible for branding and implemented central policies that applied to all enrollment directors: see cls. 4.1, 5.2, 5.3 and 4.7. Mr. Bhasin could not sell, transfer, or merge his operation without Can-Am's consent, which was not to be withheld unreasonably: see cls. 4.5 and 11.4.

6 The term of the contract was three years. Clauses 8.3 and 8.4 allowed termination on short notice for misconduct or other cause. Clause 3.3 — the provision at the centre of this case — provided that the contract would automatically renew at the end of the three-year term unless one of the parties gave six months' written notice to the contrary.

7 Mr. Hrynew, one of the respondents and another enrollment director, was a competitor of Mr. Bhasin and there was considerable animosity between them: trial reasons, at para. 461. The trial judge found, in effect, that Mr. Hrynew pressured Can-Am not to renew its Agreement with Mr. Bhasin and that Can-Am dealt dishonestly with Mr. Bhasin and ultimately gave in to that pressure.

8 When Mr. Hrynew moved his agency to Can-Am from one of its competitors many years before the events in question, Can-Am promised him that he would be given consideration for mergers that would take place and he in fact merged with other agencies in Calgary after joining Can-Am: trial reasons, at para. 238. He was in a strong position with Can-Am because he had the largest agency in Alberta and a good working relationship with the Alberta Securities Commission which regulated Can-Am's business: para. 284.

9 Mr. Hrynew wanted to capture Mr. Bhasin's lucrative niche market around which he had built his business: trial reasons, at para. 303. Mr. Hrynew personally approached Mr. Bhasin to propose a merger of their agencies on numerous occasions: para. 238. He also actively encouraged Can-Am to force the merger and made "veiled threats" that he would leave if no merger took place: para. 282; see also paras. 251 and 287. The trial judge found that the proposed "merger" was in effect a hostile takeover of Mr. Bhasin's agency by Mr. Hrynew: para. 240. Mr. Bhasin steadfastly refused to participate in such a merger: para. 247.

10 The Alberta Securities Commission raised concerns about compliance issues among Can-Am's enrollment directors. In late 1999, the Commission required Can-Am to appoint a single provincial trading officer ("PTO") to review its enrollment directors for compliance with securities laws: trial reasons, at paras. 149, 152 and 160. Can-Am appointed Mr. Hrynew to that position in September of that year. The role required him to conduct audits of Can-Am's enrollment directors. Mr. Bhasin and Mr. Hon, another enrollment director, objected to having Mr. Hrynew, a competitor, review their confidential business records: paras. 189-196.

11 Can-Am became worried that the Commission might revoke its licence and, in 1999 and 2000, it had many discussions with the Commission about compliance. During those discussions, it was clear that Can-Am was considering a restructuring of its agencies in Alberta that involved Mr. Bhasin. In June 2000, Can-Am outlined its plans to the Commission and they included Mr. Bhasin working for Mr. Hrynew's agency. The trial judge found that this plan had been formulated before June 2000: trial reasons, at para. 256. None of this was known by Mr. Bhasin: paras. 243-46.

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12 In fact, Can-Am repeatedly misled Mr. Bhasin by telling him that Mr. Hrynew, as PTO, was under an obligation to treat the information confidentially and that the Commission had rejected a proposal to have an outside PTO, neither of which was true: trial reasons at para. 195. It also responded equivocally when Mr. Bhasin asked in August 2000 whether the merger was a "done deal": para. 247. When Mr. Bhasin continued to refuse to allow Mr. Hrynew to audit his records, Can-Am threatened to terminate the 1998 Agreement and in May 2001 gave notice of non-renewal under the Agreement: paras. 207-11.

13 At the expiry of the contract term, Mr. Bhasin lost the value in his business in his assembled workforce. The majority of his sales agents were successfully solicited by Mr. Hrynew's agency. Mr. Bhasin was obliged to take less remunerative work with one of Can-Am's competitors.

14 Mr. Bhasin sued Can-Am and Mr. Hrynew. Moen J. in the Alberta Court of Queen's Bench found that it was an implied term of the contract that decisions about whether to renew the contract would be made in good faith. The court held that the corporate respondent was in breach of the implied term of good faith, Mr. Hrynew had intentionally induced breach of contract, and the respondents were liable for civil conspiracy.

15 The trial judge found that Can-Am acted dishonestly with Mr. Bhasin throughout the events leading up to the non-renewal: it misled him about its intentions with respect to the merger and about the fact that it had already proposed the new structure to the Commission; it did not communicate to him that the decision was already made and final, even though he asked; and it did not communicate with him that it was working closely with Mr. Hrynew to bring about a new corporate structure with Hrynew's being the main agency in Alberta. The trial judge also found that, had Can-Am acted honestly, Mr. Bhasin could have "governed himself accordingly so as to retain the value in his agency": para. 258.

16 The Alberta Court of Appeal allowed the respondents' appeal and dismissed Mr. Bhasin's lawsuit. The court found his pleadings to be insufficient and held that the lower court erred by implying a term of good faith in the context of an unambiguous contract containing an entire agreement clause: *Bhasin v. Hrynew*, 2013 ABCA 98, 84 Alta. L.R. (5th) 68 (Alta. C.A.).

17 The appeal raises four issues:

(a) Did Mr. Bhasin properly plead breach of the duty of good faith?

(b) Did Can-Am owe Mr. Bhasin a duty of good faith? If so, did it breach that duty?

(c) Are the respondents liable for the torts of inducing breach of contract or civil conspiracy?

(d) If there was a breach, what is the appropriate measure of damages?

## III. Analysis

### *A. Did Mr. Bhasin Properly Plead Breach of the Duty of Good Faith?*

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18 The Court of Appeal held that Mr. Bhasin had not properly pleaded the good faith issue and that the trial judge had therefore erred in considering it. Mr. Bhasin contests this conclusion, while the respondents support it. I agree with Mr. Bhasin.

19 The allegations in the statement of claim clearly put the questions of improper purpose and dishonesty in issue. These facts are sufficient to put Can-Am's good faith in issue. The question of whether this conduct amounted to a breach of the duty of good faith is a legal conclusion that did not need to be pleaded separately. The defendants did not move to strike the pleadings or seek particulars of the allegation of wrongful termination in the statement of claim. Good faith was a live issue that was fully canvassed in a lengthy trial: A.F., at paras. 92-94. Written submissions by both parties at trial referred to the good faith issue and even in his opening at trial, Mr. Bhasin's counsel raised the issue of good faith.

20 The trial judge held that any deficiency in the pleadings did not cause prejudice to the respondents: paras. 23 and 48. This is an assessment she was uniquely positioned to make and her conclusion ought to be treated with deference on appeal. The good faith issue was fully argued in and addressed by the Court of Appeal and has been fully argued on the merits in this Court.

21 In my view, the trial judge did not make a reversible error by adjudicating the issue of good faith and we should address the merits of that issue.

***B. Did Can-Am Owe Mr. Bhasin a Duty of Good Faith?***

*(1) Decisions and Positions of the Parties*

**(a) Decisions**

22 The trial judge accepted Mr. Bhasin's position that there was a duty of good faith in this case and that it had been breached. In brief, her reasoning was as follows.

23 First, the trial judge decided that the 1998 Agreement was a type of agreement which as a matter of law requires good faith performance. She recognized that the 1998 Agreement did not fall within any of the existing categories of contract, such as employment, insurance and franchise agreements, which have been held to require good faith performance. She concluded, however, that the Agreement was analogous to a franchise or employment contract, and so by analogy to these cases, she implied a term of good faith performance as a matter of law. The contract was not balanced from its inception and the relationship placed the enrollment director in a position of inherent and predictable vulnerability: paras. 67-86.

24 Second and in the alternative, the trial judge held that a term of good faith performance should be implied based on the intentions of the parties in order to give business efficacy to the agreement. She concluded that "[w]hen one considers the whole of the relationship ... it is clear that the parties had to operate in good faith and there was a requirement of fairness between them. In other words, good faith was necessary to give business efficacy to the whole 1998 Agreement": para. 101.

25 The 1998 Agreement contained an "entire agreement clause" stating that there were no "agreements, express, implied or statutory, other than expressly set out" in it: cl. 11.2. The trial judge held, however, that this clause did not preclude the

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implication of a duty of good faith. The parties, she reasoned, cannot rely on exclusion clauses to avoid contractual obligations where there is an imbalance of power and that courts refuse to let parties shelter under entire agreement clauses where it would be unjust or inequitable to do so: paras. 116-18.

26 Turning to the issue of breach, the trial judge found that Can-Am had breached the agreement, first by requiring Mr. Bhasin to submit to an audit by Mr. Hrynew and to provide the latter with access to his business records, and second by exercising the non-renewal clause in a dishonest and misleading manner and for an improper purpose. The non-renewal clause was not intended to permit Can-Am to force a merger of the Bhasin and Hrynew agencies, but that was the purpose for which Can-Am exercised this power: para. 261. The trial judge also found both respondents liable for unlawful means conspiracy and found Mr. Hrynew liable for inducing Can-Am's breach of its contract with Mr. Bhasin.

27 The Court of Appeal reversed and held that there had been no breach of contract. The duty of good faith in employment contracts could not be extended by analogy to other types of contract. In any event, the duty of good faith in the employment context is limited to the manner of termination and does not include reasons for non-renewal: C.A. reasons, at paras. 27 and 31. Nor was this a circumstance in which a term could be implied because it was so obvious it was not thought necessary to mention or was necessary to make the contract work: para. 32. Even if there were an implied duty of good faith in this case, the impugned conduct concerned the non-renewal of a contract, which occurs on expiry, unlike a termination clause: para. 31.

28 Moreover, the Court of Appeal held that a term cannot be implied where it goes against an express term of the contract. Here, the parties did not intend a perpetual contract, since they included a term allowing either party to unilaterally trigger its expiration prior to the end of each three-year term. The trial judge's approach was inconsistent with the non-renewal provision of the contract. The motive for triggering expiration was not restricted under the Agreement. The implication of a term of good faith also violated the entire agreement clause. The court held that the evidence of assurances given by Can-Am as to how the non-renewal power would be exercised fell afoul of the parol evidence rule and should not have been considered. Since the Court of Appeal held there was no breach of contract, the basis for the claims in unlawful means conspiracy and inducing breach of contract also disappeared.

**(b) Positions of the Parties**

29 Mr. Bhasin advances two related positions on appeal. His broad submission is that the Court should recognize a general duty of good faith in contract. The duty arises where the agreement gives the defendant the power to unilaterally defeat a legitimate contractual objective of the plaintiff and it does not clearly allow the defendant to exercise its power without regard for that objective: A.F., at para. 51. This duty of good faith prevents conduct which, while consonant with the letter of a contract, exhibits dishonesty, ill will, improper motive or similar departures from reasonable business expectations. Mr. Bhasin contends that common law in Canada is increasingly isolated as other jurisdictions embrace a greater role for good faith in contract law: A.F., at paras. 27-32. The recognition of a general duty of good faith would constitute an incremental advance in the law, given the numerous specific situations that already give rise to a duty of good faith. Mr. Bhasin relies on the findings of the trial judge that the respondents improperly and dishonestly used its non-renewal right to compel Mr. Bhasin to merge with his competitor. Mr. Bhasin contends that the respondents had no legitimate business reason for not renewing the contract. He also says that the entire agreement clause should be construed narrowly, and that express language is needed for such a clause to derogate from a duty of good faith: A.F., at para. 83.

30 Mr. Bhasin's second position, emphasized in oral argument, is that the Court should at least recognize a duty of honest performance of contractual obligations: transcript, at pp. 8, 10 and 24. Mr. Bhasin relies on the trial judge's findings that Can-Am acted dishonestly towards Mr. Bhasin throughout the period leading up to the non-renewal. It repeatedly lied to him

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about the nature of the organizational changes required by the Alberta Securities Commission, the nature of the audits that were to be carried out by Mr. Hrynew, and was dishonest about its intention to force him out: trial reasons, at paras. 195, 221, 246-47 and 267.

31 Unsurprisingly, the respondents see things very differently. While they accept that good faith plays a role in Canadian contract law, they submit that this role is much more modest than Mr. Bhasin suggests. They say that such a duty arises only in certain classes of contract, such as employment contracts, and in contracts involving discretionary powers: R.F., at para. 52. In the employment context, the duty applies only to the manner in which a contract is terminated. The contract in this case was negotiated between commercial parties to whom the policy considerations underlying employment law doctrine do not apply. Mr. Bhasin is alleging a right to a perpetual, or at least indefinite, contract with the respondents. The contract in this case could not be said to be discretionary, because it provided simply that on six months notice either party could terminate the Agreement. The respondents submit that there is no ambiguity in the wording of the non-renewal clause of the contract and so there is no basis for implying other terms or for relying on extrinsic evidence of the parties' intentions. The entire agreement clause specifically precluded the implication of any terms other than the express terms of the contract.

*(2) Analysis*

**(a) Overview**

32 The notion of good faith has deep roots in contract law and permeates many of its rules. Nonetheless, Anglo-Canadian common law has resisted acknowledging any generalized and independent doctrine of good faith performance of contracts. The result is an "unsettled and incoherent body of law" that has developed "piecemeal" and which is "difficult to analyze": Ontario Law Reform Commission ("OLRC"), *Report on Amendment of the Law of Contract* (1987), at p. 169. This approach is out of step with the civil law of Quebec and most jurisdictions in the United States and produces results that are not consistent with the reasonable expectations of commercial parties.

33 In my view, it is time to take two incremental steps in order to make the common law less unsettled and piecemeal, more coherent and more just. The first step is to acknowledge that good faith contractual performance is a general organizing principle of the common law of contract which underpins and informs the various rules in which the common law, in various situations and types of relationships, recognizes obligations of good faith contractual performance. The second is to recognize, as a further manifestation of this organizing principle of good faith, that there is a common law duty which applies to all contracts to act honestly in the performance of contractual obligations.

34 In my view, taking these two steps is perfectly consistent with the Court's responsibility to make incremental changes in the common law when appropriate. Doing so will put in place a duty that is just, that accords with the reasonable expectations of commercial parties and that is sufficiently precise that it will enhance rather than detract from commercial certainty.

**(b) Good Faith as a General Organizing Principle**

***(i) Background***

35 The doctrine of good faith traces its history to Roman law and found acceptance in earlier English contract law. For

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example, Lord Northington wrote in *Aleyn v. Belchier* (1758), 1 Eden 132, 28 E.R. 634 (Eng. Ch.), at p. 138, cited in *Mills v. Mills* (1938), 60 C.L.R. 150 (Australia H.C.), at p. 185, that "[n]o point is better established than that, a person having a power, must execute it *bona fide* for the end designed, otherwise it is corrupt and void." Similarly, Lord Kenyon wrote in *Mellish v. Motteux* (1792), Peake 156, 170 E.R. 113 (Eng. K.B.), "in contracts of all kinds, it is of the highest importance that courts of law should compel the observance of honesty and good faith": p. 157. In *Carter v. Boehm* (1766), 3 Burr. 1905, 97 E.R. 1162 (Eng. K.B.), at p. 1910, Lord Mansfield stated that good faith is a principle applicable to all contracts: see also *Herbert v. Mercantile Fire Insurance Co.* (1878), 43 U.C.Q.B. 384 (Ont. Q.B.); R. Powell, "Good Faith in Contracts" (1956), 9 Curr. Legal Probs. 16.

36 However, these broad pronouncements have been, for the most part, restricted by subsequent jurisprudence to specific types of contracts and relationships, such as insurance contracts, leaving unclear the role of the broader principle of good faith in the modern Anglo-Canadian law of contracts: *Chitty on Contracts* (31st ed. 2012), at para. 1-039; W. P. Yee, "Protecting Parties' Reasonable Expectations: A General Principle of Good Faith" (2001), 1 *O.U.C.L.J.* 195, at p. 195; E. P. Belobaba, "Good Faith in Canadian Contract Law", in *Special Lectures of the Law Society of Upper Canada 1985 — Commerical Law: Recent Developments and Emerging Trends* (1985), 73, at p. 75. One leading Canadian contracts scholar went so far as to say that the common law has taken a "kind of perverted pride" in the absence of any general notion of good faith, as if accepting that notion "would be admitting to the presence of some kind of embarrassing social disease": J. Swan, "Whither Contracts: A Retrospective and Prospective Overview", in *Special Lectures of the Law Society of Upper Canada 1984 — Law in Transition: Contracts* (1984), 125, at p. 148.

37 This Court has not examined whether there is a general duty of good faith contractual performance. However, there has been an active debate in other courts and among scholars for decades over whether there is, or should be, a general or "stand-alone" duty of good faith in the performance of contracts. Canadian courts have reached different conclusions on this point.

38 Some suggest that there is a general duty of good faith: *Gateway Realty Ltd. v. Arton Holdings Ltd.* (1991), 106 N.S.R. (2d) 180 (N.S. T.D.), aff'd on narrower grounds (1992), 112 N.S.R. (2d) 180 (N.S. C.A.); *McDonald's Restaurants of Canada Ltd. v. British Columbia* (1997), 29 B.C.L.R. (3d) 303 (B.C. C.A.), at para. 99; *Crawford v. New Brunswick (Agricultural Development Board)* (1997), 192 N.B.R. (2d) 68 (N.B. C.A.), at paras. 7-8. They see a broad role for good faith as an implied term in all contracts that establishes minimum standards of acceptable commercial behaviour. As Kelly J. put it in *Gateway Realty*, at para. 38:

> The law requires that parties to a contract exercise their rights under that agreement honestly, fairly and in good faith. This standard is breached when a party acts in a bad faith manner in the performance of its rights and obligations under the contract. "Good faith" conduct is the guide to the manner in which the parties should pursue their mutual contractual objectives. Such conduct is breached when a party acts in "bad faith" — a conduct that is contrary to community standards of honesty, reasonableness or fairness.

39 Other courts are of the view that there exists no such general duty of good faith in all contracts: *Transamerica Life Canada Inc. v. ING Canada Inc.* (2003), 68 O.R. (3d) 457 (Ont. C.A.), at para. 54; *Mesa Operating Ltd. Partnership v. Amoco Canada Resources Ltd.* (1994), 149 A.R. 187 (Alta. C.A.), at paras. 15-19, *per* Kerans J.A., *dubitante*; *Barclays Bank PLC v. Metcalfe & Mansfield Alternative Investments VII Corp.*, 2013 ONCA 494, 365 D.L.R. (4th) 15 (Ont. C.A.), at para. 131; see G. R. Hall, *Canadian Contractual Interpretation Law* (2nd ed. 2012), at pp. 338-46. The detractors of such a general duty of good faith have accepted a limited role for good faith in certain contexts but have held that it would create commercial uncertainty and undermine freedom of contract to recognize a general duty of good faith that would permit courts to interfere with the express terms of a contract.

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40 This Court ought to develop the common law to keep in step with the "dynamic and evolving fabric of our society" where it can do so in an incremental fashion and where the ramifications of the development are "not incapable of assessment": *R. v. Salituro*, [1991] 3 S.C.R. 654 (S.C.C.), at p. 670; *Bow Valley Husky (Bermuda) Ltd. v. Saint John Shipbuilding Ltd.*, [1997] 3 S.C.R. 1210 (S.C.C.), at para. 93; see also *Watkins v. Olafson*, [1989] 2 S.C.R. 750 (S.C.C.), at pp. 760-64; *Hill v. Church of Scientology of Toronto*, [1995] 2 S.C.R. 1130 (S.C.C.), at para. 85; *Pepsi-Cola Canada Beverages (West) Ltd. v. R.W.D.S.U., Local 558*, 2002 SCC 8, [2002] 1 S.C.R. 156 (S.C.C.); *British Columbia v. Imperial Tobacco Canada Ltd.*, 2005 SCC 49, [2005] 2 S.C.R. 473 (S.C.C.); *Grant v. Torstar Corp.*, 2009 SCC 61, [2009] 3 S.C.R. 640 (S.C.C.), at para. 46. This is even more appropriate where, as here, what is contemplated is not the reversal of some settled rule, but a development directed to bringing greater certainty and coherence to a complex and troublesome area of the common law.

41 As I see it, the developments that I propose are desirable as a result of several considerations. First, the current Canadian common law is uncertain. Second, the current approach to good faith performance lacks coherence. Third, the current law is out of step with the reasonable expectations of commercial parties, particularly those of at least two major trading partners of common law Canada — Quebec and the United States: see, e.g., Hall, at p. 347. While the developments which I propose will not completely address these problems, they will bring a measure of coherence and predictability to the law and will bring the law closer to what reasonable commercial parties would expect it to be.

***(ii) Survey of the Current State of the Common Law***

42 Anglo-Canadian common law has developed a number of rules and doctrines that call upon the notion of good faith in contractual dealings; it is a concept that underlies many elements of modern contract law: S. M. Waddams, *The Law of Contracts* (2010), at para. 550; J. D. McCamus *The Law of Contracts* (2nd ed. 2012), at pp. 835-38; OLRC, at p. 165; Belobaba, at pp. 75-76; J. F. O'Connor, *Good Faith in English Law* (1990), at pp. 17-49; J. Steyn, "Contract Law: Fulfilling the Reasonable Expectations of Honest Men" (1997), 113 *Law Q. Rev.* 433. The approach, not unfairly, has been characterized as developing "piecemeal solutions in response to demonstrated problems": *Interfoto Library Ltd. v. Stiletto Visual Programmes Ltd.* (1987), [1989] 1 Q.B. 433 (Eng. C.A.), at p. 439, *per* Bingham L.J. (as he then was). Thus we see, for example, that good faith notions have been applied to particular types of contracts, particular types of contractual provisions and particular contractual relationships. It also underlies doctrines that explicitly deal with fairness in contracts, such as unconscionability, and plays a role in interpreting and implying contractual terms. The difficulty with this "piecemeal" approach, however, is that it often fails to take a consistent or principled approach to similar problems. A brief review of the current landscape of good faith will show the extent to which this is the case.

43 Considerations of good faith are apparent in doctrines that expressly consider the fairness of contractual bargains, such as unconscionability. This doctrine is based on considerations of fairness and preventing one contracting party from taking undue advantage of the other: G. H. L. Fridman, *The Law of Contract in Canada* (6th ed. 2011), at pp. 329-30; E. Peden, "When Common Law Trumps Equity: the Rise of Good Faith and Reasonableness and the Demise of Unconscionability" (2005), 21 *J.C.L.* 226; Belobaba, at p. 86; S. M. Waddams, "Good Faith, Unconscionability and Reasonable Expectations" (1995), 9 J.C.L. 55.

44 Good faith also plays a role in the law of implied terms, particularly with respect to terms implied by law. Terms implied by law redress power imbalances in certain classes of contracts such as employment, landlord-lessee, and insurance contracts: *London Drugs Ltd. v. Kuehne & Nagel International Ltd.*, [1992] 3 S.C.R. 299 (S.C.C.), at p. 457, *per* McLachlin J.; see also *Machtinger v. HOJ Industries Ltd.*, [1992] 1 S.C.R. 986 (S.C.C.), *per* McLachlin J., concurring. The implication of terms plays a functionally similar role in common law contract law to the doctrine of good faith in civil law jurisdictions by filling in gaps in the written agreement of the parties: *Chitty on Contracts*, at para. 1-051. In *Mesa Operating*, the Alberta Court of Appeal implied a term that a power of pooling properties for the purpose of determining royalty payments be exercised reasonably. The court implied this term in order to give effect to the intentions of the parties rather than as a requirement of good faith, but

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Kerans J.A. stated that "[t]he rule that governs here can, therefore, be expressed much more narrowly than to speak of good faith, although I suspect it is in reality the sort of thing some judges have in mind when they speak of good faith": para. 22. Many other examples may be found in Waddams, *The Law of Contracts*, at paras. 499-506.

45 Considerations of good faith are also apparent in contract interpretation: *Chitty on Contracts*, at para. 1-050; Hall, at p. 347. The primary object of contractual interpretation is of course to give effect to the intentions of the parties at the time of contract formation. However, considerations of good faith inform this process. Parties may generally be assumed to intend certain minimum standards of conduct. Further, as Lord Reid observed in *L. Schuler A.G. v. Wickman Machine Tool Sales Ltd.* (1973), [1974] A.C. 235 (U.K. H.L.), at p. 251, "[t]he more unreasonable the result the more unlikely it is that the parties can have intended it". As A. Swan and J. Adamski put it, the duty of good faith "is not an externally imposed requirement but inheres in the parties' relation": *Canadian Contract Law* (3rd ed. 2012), at §§ 8.134 to 8.146.

46 Good faith also appears in numerous contexts in a more explicit form. The concept of "good faith" is used in hundreds of statutes across Canada, including statutory duties of good faith and fair dealing in franchise legislation and good faith bargaining in labour law: S. K. O'Byrne, "Good Faith in Contractual Performance: Recent Developments" (1995), 74 *Can. Bar Rev.* 70, at p. 71.

47 There have been many attempts to bring a measure of coherence to this piecemeal accretion of appeals to good faith: see, among many others, McCamus, at pp. 835-68; S. K. O'Byrne, "The Implied Term of Good Faith and Fair Dealing: Recent Developments" (2007), 86 *Can. Bar. Rev.* 193, at pp. 196-204; Waddams, *The Law of Contracts*, at paras. 494-508; R. S. Summers, "'Good Faith' in General Contract Law and the Sales Provisions of the Uniform Commercial Code" (1968), 54 Va. L. Rev. 195; S. J. Burton, "Breach of Contract and the Common Law Duty to Perform in Good Faith" (1980), 94 *Harv. L. Rev.* 369. By way of example, Professor McCamus has identified three broad types of situations in which a duty of good faith performance of some kind has been found to exist: (1) where the parties must cooperate in order to achieve the objects of the contract; (2) where one party exercises a discretionary power under the contract; and (3) where one party seeks to evade contractual duties (pp. 840-56; *CivicLife.com Inc. v. Canada (Attorney General)* (2006), 215 O.A.C. 43 (Ont. C.A.), at paras. 49-50).

48 While these types of cases overlap to some extent, they provide a useful analytical tool to appreciate the current state of the law on the duty of good faith. They also reveal some of the lack of coherence in the current approach. It is often unclear whether a good faith obligation is being imposed as a matter of law, as a matter of implication or as a matter of interpretation. Professor McCamus notes:

> Although the line between the two types of implication is difficult to draw, it may be realistic to assume that implied duties of good faith are likely, on occasion at least, to slide into the category of legal incidents rather than mere presumed intentions. Certainly, it would be difficult to defend the implication of terms on each of the cases considered here on the basis of the traditional business efficiency or officious bystander test. In the control of contractual discretion cases, for example, it may be more realistic to suggest that the implied limitation on the exercise of the discretion is intended to give effect to the "reasonable expectations of the parties." [pp. 865-66]

49 The first type of situation (contracts requiring the cooperation of the parties to achieve the objects of the contract) is reflected in the jurisprudence of this Court. In *Dynamic Transport Ltd. v. O.K. Detailing Ltd.*, [1978] 2 S.C.R. 1072 (S.C.C.), the parties to a real estate transaction failed to specify in the purchase-sale agreement which party was to be responsible for obtaining planning permission for a subdivision of the property. By law, the vendor was the only party capable of obtaining such permission. The Court held that the vendor was under an obligation to use reasonable efforts to secure the permission, or

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as Dickson J. put it, "[t]he vendor is under a duty to act in good faith and to take all reasonable steps to complete the sale": p. 1084. It is not completely clear whether this duty was imposed as a matter of law or was implied based on the parties' intentions: see p. 1083; see also *Gateway Realty* and *CivicLife.com*.

50 *Mitsui & Co. (Canada) Ltd. v. Royal Bank*, [1995] 2 S.C.R. 187 (S.C.C.), is an example of the second type of situation (exercise of contractual discretion). The lease of a helicopter included an option to buy at the "reasonable fair market value of the helicopter as established by Lessor": para. 2. This Court held, at para. 34, that, "[c]learly, the lessor is not in a position, by virtue of clause 32, to make any offer that it may feel is appropriate. It is contractually bound to act in good faith to determine the reasonable fair market value of the helicopters, which is the price that the parties had initially agreed would be the exercise price of the option." The Court did not discuss the basis for implying the term, but suggested that in the absence of a reasonableness requirement, the option would be a mere agreement to agree and thus would be unenforceable, which means that the implication of the term was necessary to give business efficacy to the agreement.

51 This Court's decision in *Freedman v. Mason*, [1958] S.C.R. 483 (S.C.C.), falls in the third type of situation in which a duty of good faith arises (where a contractual power is used to evade a contractual duty). In that case, the vendor in a real estate transaction regretted the bargain he had made. He then sought to repudiate the contract by failing to convey title in fee simple because he claimed his wife would not provide a bar of dower. The issue was whether he could take advantage of a clause permitting him to repudiate the transaction in the event that he was "unable or unwilling" to remove this defect in title even though he had made no efforts to do so by trying to obtain the bar of dower. Judson J. held that the clause did not "enable a person to repudiate a contract for a cause which he himself has brought about" or permit "a capricious or arbitrary repudiation": p. 486. On the contrary, "[a] vendor who seeks to take advantage of the clause must exercise his right reasonably and in good faith and not in a capricious or arbitrary manner": p. 487.

52 The jurisprudence is not always very clear about the source of the good faith obligations found in these cases. The categories of terms implied as a matter of law, terms implied as a matter of intention and terms arising as a matter of interpretation sometimes are blurred or even ignored, resulting in uncertainty and a lack of coherence at the level of principle.

53 Apart from these types of situations in which a duty of good faith arises, common law Canadian courts have also recognized that there are classes of relationships that call for a duty of good faith to be implied by law.

54 For example, this court confirmed that there is a duty of good faith in the employment context in *Keays v. Honda Canada Inc.*, 2008 SCC 39, [2008] 2 S.C.R. 362 (S.C.C.). Mr. Keays was diagnosed with chronic fatigue syndrome and was frequently absent from work. Honda grew concerned with the frequency of the absences. It ordered Mr. Keays to undergo an examination by a doctor chosen by the employer, required him to provide a doctor's note for any absences, and discouraged him from retaining outside counsel. The majority held that in all employment contracts there was an implied term of good faith governing the manner of termination. In particular, the employer should not engage in conduct that is "unfair or is in bad faith by being, for example, untruthful, misleading or unduly insensitive" when dismissing an employee: para. 57, citing *Wallace v. United Grain Growers Ltd.*, [1997] 3 S.C.R. 701 (S.C.C.), at para. 98. Good faith in this context did not extend to the employer's reasons for terminating the contract of employment because this would undermine the right of an employer to determine the composition of its workforce: *Wallace*, at para. 76.

55 This Court has also affirmed the duty of good faith which requires an insurer to deal with its insured's claim fairly, both with respect to the manner in which it investigates and assesses the claim and to the decision whether or not to pay it: *Fidler v. Sun Life Assurance Co. of Canada*, 2006 SCC 30, [2006] 2 S.C.R. 3 (S.C.C.), at para. 63, citing *702535 Ontario Inc. v.*

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*Non-Marine Underwriters, Lloyd's London, England* (2000), 184 D.L.R. (4th) 687 (Ont. C.A.), at para. 29. The breach of this duty may support an award of punitive damages: *Whiten v. Pilot Insurance Co.*, 2002 SCC 18, [2002] 1 S.C.R. 595 (S.C.C.). This duty of good faith is also reciprocal: the insurer must not act in bad faith when dealing with a claim, which is typically made by someone in a vulnerable situation, and the insured must act in good faith by disclosing facts material to the insurance policy (para. 83, citing *Andrusiw v. Aetna Life Insurance Co. of Canada* (2001), 289 A.R. 1 (Alta. Q.B.), at paras. 84-85, *per* Murray J.).

56 This Court has also recognized that a duty of good faith, in the sense of fair dealing, will generally be implied in fact in the tendering context. When a company tenders a contract, it comes under a duty of fairness in considering the bids submitted under the tendering process, as a result of the expense incurred by parties submitting these bids: *Martel Building Ltd. v. R.*, 2000 SCC 60, [2000] 2 S.C.R. 860 (S.C.C.), at para. 88; see also *M.J.B. Enterprises Ltd. v. Defence Construction (1951) Ltd.*, [1999] 1 S.C.R. 619 (S.C.C.); *Tercon Contractors Ltd. v. British Columbia (Minister of Transportation & Highways)*, 2010 SCC 4, [2010] 1 S.C.R. 69 (S.C.C.), at paras. 58-59; A. C. McNeely, *Canadian Law of Competitive Bidding and Procurement* (2010), at pp. 245-54.

57 Developments in the United Kingdom and Australia point to enhanced attention to the notion of good faith, mitigated by reluctance to embrace it as a stand-alone doctrine. Good faith in contract performance has received increasing prominence in English law, despite its "traditional ... hostility" to the concept: *Yam Seng Pte Ltd. v. International Trade Corp Ltd.*, [2013] EWHC 111, [2013] 1 All E.R. (Comm) 1321 (Eng. Q.B.), at para. 123, citing E. McKendrick, *Contract Law* (9th ed. 2011), at pp. 221-22; see also *Chitty on Contracts*, at para. 1-039. In *Yam Seng*, Leggatt J. held that a number of specific duties embodying good faith can be implied according to the presumed intentions of the parties according to the traditional approach for implying terms: para. 131. Leggatt J. identified a number of these implied duties, including honesty, fidelity to the parties' bargain, cooperation, and fair dealing: paras. 135-50. Leggatt J. stated that "[a] paradigm example of a general norm which underlies almost all contractual relationships is an expectation of honesty. That expectation is essential to commerce, which depends critically on trust": para. 135; see D. Campbell, "Good Faith and the Ubiquity of the 'Relational' Contract'" (2014), 77 *Mod. L. Rev.* 475. The Court of Appeal considered the *Yam Seng* decision in *Mid Essex Hospital Services NHS Trust v. Compass Group UK and Ireland Ltd.*, [2013] EWCA Civ 200 (Eng. C.A.) (BAILII), where it confirmed that good faith was not a general principle of English law, but that it could be an implied term in certain categories of cases: paras. 105 and 150.

58 Australian courts have also moved towards a greater role for good faith in contract performance: *Cheshire and Fifoot's Law of Contract*, (9th Australian ed. 2008), at 10.43 to 10.47. The duty of good faith in its modern form was recognized by Priestley J.A. in *Renard Constructions (ME) Pty. Ltd. v. Canada (Minister of Public Works)* (1992), 26 N.S.W.L.R. 234 (New South Wales C.A.). There is no generally applicable duty of good faith, but one will be implied into contracts in certain circumstances. The duty of good faith can be implied as a matter of law or as a matter of fact, although the cases are not always clear on the basis on which the term is being implied. Australian courts have taken a broad view of what constitutes good faith: see, e.g., *Burger King Corp. v. Hungry Jacks 's Pty Ltd.*, [2001] NSWCA 187 (New South Wales C.A.) (AustLII). The law of good faith performance in Australia is still developing and remains unsettled: E. Peden, "Good faith in the performance of contract law" (2004), 42: 9 *L.S.J.* 64, at p. 64. However, it is clear that the duty of good faith requires adherence to standards of honest conduct: A. Mason, "Contract, Good Faith and Equitable Standards in Fair Dealing" (2000), 116 *Law Q. Rev.* 66, at p. 76; *Burger King*, at paras. 171 and 189.

***(iii) The Way Forward***

59 This selective survey supports the view that Canadian common law in relation to good faith performance of contracts is piecemeal, unsettled and unclear: Belobaba; O'Byrne, "Good Faith in Contractual Performance", at p. 95; B. J. Reiter, "Good Faith in Contracts" (1983), 17 *Val. U.L. Rev.* 705, at pp. 711-12. It also shows that in Canada, as well as in the United Kingdom and Australia, there is increasing attention to the notion of good faith, particularly in the area of contractual performance.

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Opponents of any general obligation of good faith prefer the traditional, organic development of solutions to address particular problems as they arise: see, e.g., M. G. Bridge, "Does Anglo-Canadian Contract Law Need a Doctrine of Good Faith?" (1984), 9 *Can. Bus. L.J.* 385; D. Clark, "Some Recent Developments in the Canadian Law of Contracts" (1993), 14 *Advocates' Q.* 435, at pp. 436 and 440. However, foreclosing some incremental development of the law at the level of principle would go beyond what prudent caution requires and evidence an almost "perverted pride" — to use Swan's term — in the law's failings.

60 Commercial parties reasonably expect a basic level of honesty and good faith in contractual dealings. While they remain at arm's length and are not subject to the duties of a fiduciary, a basic level of honest conduct is necessary to the proper functioning of commerce. The growth of longer term, relational contracts that depend on an element of trust and cooperation clearly call for a basic element of honesty in performance, but, even in transactional exchanges, misleading or deceitful conduct will fly in the face of the expectations of the parties: see Swan and Adamski, at §1.24.

61 The fact that commercial parties expect honesty on the part of their contracting partners can also be seen from the fact that it was the American Bar Association's Section of Corporation, Banking and Business Law that urged the adoption of "honesty in fact" in the original drafting of the Uniform Commercial Code ("U.C.C."): E. A. Farnsworth, "Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code" (1963), 30 *U. Chicago L. Rev.* 666, at p. 673. Moreover, empirical research suggests that commercial parties do in fact expect that their contracting parties will conduct themselves in good faith: see, e.g., S. Macaulay, "Non-contractual Relations in Business: A Preliminary Study" (1963), 28 *Am. Soc. Rev.* 55, at p. 58; H. Beale and T. Dugdale, "Contracts Between Businessmen: Planning and the Use of Contractual Remedies" (1975), 2 *Brit. J. Law. & Soc.* 45, at pp. 47-48; S. Macaulay, "An Empirical View of Contract", [1985] *Wis. L. Rev.* 465; V. Goldwasser and T. Ciro, "Standards of Behaviour in Commercial Contracting" (2002), 30 *A.B.L.R.* 369, at pp. 372-77. It is, to say the least, counterintuitive to think that reasonable commercial parties would accept a contract which contained a provision to the effect that they were not obliged to act honestly in performing their contractual obligations.

62 I conclude from this review that enunciating a general organizing principle of good faith and recognizing a duty to perform contracts honestly will help bring certainty and coherence to this area of the law in a way that is consistent with reasonable commercial expectations.

***(iv) Towards an Organizing Principle of Good Faith***

63 The first step is to recognize that there is an organizing principle of good faith that underlies and manifests itself in various more specific doctrines governing contractual performance. That organizing principle is simply that parties generally must perform their contractual duties honestly and reasonably and not capriciously or arbitrarily.

64 As the Court has recognized, an organizing principle states in general terms a requirement of justice from which more specific legal doctrines may be derived. An organizing principle therefore is not a free-standing rule, but rather a standard that underpins and is manifested in more specific legal doctrines and may be given different weight in different situations: see, e.g., *R. v. Jones*, [1994] 2 S.C.R. 229 (S.C.C.), at p. 249; *R. v. Hart*, 2014 SCC 52, [2014] 2 S.C.R. 544 (S.C.C.), at para. 124; R. M. Dworkin, "Is Law a System of Rules?", in R. M. Dworkin, ed., *The Philosophy of Law* (1977), 38, at p. 47. It is a standard that helps to understand and develop the law in a coherent and principled way.

65 The organizing principle of good faith exemplifies the notion that, in carrying out his or her own performance of the contract, a contracting party should have appropriate regard to the legitimate contractual interests of the contracting partner.

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While "appropriate regard" for the other party's interests will vary depending on the context of the contractual relationship, it does not require acting to serve those interests in all cases. It merely requires that a party not seek to undermine those interests in bad faith. This general principle has strong conceptual differences from the much higher obligations of a fiduciary. Unlike fiduciary duties, good faith performance does not engage duties of loyalty to the other contracting party or a duty to put the interests of the other contracting party first.

66 This organizing principle of good faith manifests itself through the existing doctrines about the types of situations and relationships in which the law requires, in certain respects, honest, candid, forthright or reasonable contractual performance. Generally, claims of good faith will not succeed if they do not fall within these existing doctrines. But we should also recognize that this list is not closed. The application of the organizing principle of good faith to particular situations should be developed where the existing law is found to be wanting and where the development may occur incrementally in a way that is consistent with the structure of the common law of contract and gives due weight to the importance of private ordering and certainty in commercial affairs.

67 This approach is consistent with that taken in the case of unjust enrichment. McLachlin J. (as she then was) outlined the approach in *Peel (Regional Municipality) v. Canada*, [1992] 3 S.C.R. 762 (S.C.C.), at pp. 786 and 788:

> This case presents the Court with the difficult task of mediating between, if not resolving, the conflicting views of the proper scope of the doctrine of unjust enrichment. It is my conclusion that we must choose a middle path; one which acknowledges the importance of proceeding on general principles but seeks to reconcile the principles with the established categories of recovery ....
>
> . . . . .
>
> The tri-partite principle of general application which this Court has recognized as the basis of the cause of action for unjust enrichment is thus seen to have grown out of the traditional categories of recovery. It is informed by them. It is capable, however, of going beyond them, allowing the law to develop in a flexible way as required to meet changing perceptions of justice.

68 The flexible approach that was taken in *Peel* recognizes that "[a]t the heart of the doctrine of unjust enrichment, whether expressed in terms of the traditional categories of recovery or general principle, lies the notion of restoration of a benefit which justice does not permit one to retain": p. 788. In that case, this Court further developed the law through application of an organizing principle without displacing the existing specific doctrines. This is what I propose to do with regards to the organizing principle of good faith.

69 The approach of recognizing an overarching organizing principle but accepting the existing law as the primary guide to future development is appropriate in the development of the doctrine of good faith. Good faith may be invoked in widely varying contexts and this calls for a highly context-specific understanding of what honesty and reasonableness in performance require so as to give appropriate consideration to the legitimate interests of both contracting parties. For example, the general organizing principle of good faith would likely have different implications in the context of a long-term contract of mutual cooperation than it would in a more transactional exchange: Swan and Adamski, at § 1.24; B. Dixon, "Common law obligations of good faith in Australian commercial contracts — a relational recipe" (2005), 33 *A.B.L.R.* 87.

70 The principle of good faith must be applied in a manner that is consistent with the fundamental commitments of the common law of contract which generally places great weight on the freedom of contracting parties to pursue their individual self-interest. In commerce, a party may sometimes cause loss to another — even intentionally — in the legitimate pursuit of

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economic self-interest: *Bram Enterprises Ltd. v. A.I. Enterprises Ltd.*, 2014 SCC 12, [2014] 1 S.C.R. 177 (S.C.C.), at para. 31. Doing so is not necessarily contrary to good faith and in some cases has actually been encouraged by the courts on the basis of economic efficiency: *Bank of America Canada v. Mutual Trust Co.*, 2002 SCC 43, [2002] 2 S.C.R. 601 (S.C.C.), at para. 31. The development of the principle of good faith must be clear not to veer into a form of *ad hoc* judicial moralism or "palm tree" justice. In particular, the organizing principle of good faith should not be used as a pretext for scrutinizing the motives of contracting parties.

71 Tying the organizing principle to the existing law mitigates the concern that any general notion of good faith in contract law will undermine certainty in commercial contracts. In my view, this approach strikes the correct balance between predictability and flexibility.

***(v) Should There Be a New Duty?***

72 In my view, the objection to Can-Am's conduct in this case does not fit within any of the existing situations or relationships in which duties of good faith have been found to exist. The relationship between Can-Am and Mr. Bhasin was not an employment or franchise relationship. Classifying the decision not to renew the contract as a contractual discretion would constitute a significant expansion of the decided cases under that type of situation. After all, a party almost always has some amount of discretion in how to perform a contract. It would also be difficult to say that a duty of good faith should be implied in this case on the basis of the intentions of the parties given the clear terms of an entire agreement clause in the Agreement. The key question before the Court, therefore, is whether we ought to create a new common law duty under the broad umbrella of the organizing principle of good faith performance of contracts.

73 In my view, we should. I would hold that there is a general duty of honesty in contractual performance. This means simply that parties must not lie or otherwise knowingly mislead each other about matters directly linked to the performance of the contract. This does not impose a duty of loyalty or of disclosure or require a party to forego advantages flowing from the contract; it is a simple requirement not to lie or mislead the other party about one's contractual performance. Recognizing a duty of honest performance flowing directly from the common law organizing principle of good faith is a modest, incremental step. The requirement to act honestly is one of the most widely recognized aspects of the organizing principle of good faith: see Swan and Adamski, at § 8.135; O'Byrne, "Good Faith in Contractual Performance", at p. 78; Belobaba; *Greenberg v. Meffert* (1985), 50 O.R. (2d) 755 (Ont. C.A.), at p. 764; *Gateway Realty*, at para. 38, *per* Kelly J.; *Shelanu Inc. v. Print Three Franchising Corp.* (2003), 64 O.R. (3d) 533 (Ont. C.A.), at para. 69. For example, the duty of honesty was a key component of the good faith requirements which have been recognized in relation to termination of employment contracts: *Wallace*, at para. 98; *Honda Canada*, at para. 58.

74 There is a longstanding debate about whether the duty of good faith arises as a term implied as a matter of fact or a term implied by law: see *Mesa Operating*, at paras. 15-19. I do not have to resolve this debate fully, which, as I reviewed earlier, casts a shadow of uncertainty over a good deal of the jurisprudence. I am at this point concerned only with a new duty of honest performance and, as I see it, this should not be thought of as an implied term, but a general doctrine of contract law that imposes as a contractual duty a minimum standard of honest contractual performance. It operates irrespective of the intentions of the parties, and is to this extent analogous to equitable doctrines which impose limits on the freedom of contract, such as the doctrine of unconscionability.

75 Viewed in this way, the entire agreement clause in cl. 11.2 of the Agreement is not an impediment to the duty arising in this case. Because the duty of honesty in contractual performance is a general doctrine of contract law that applies to all contracts, like unconscionability, the parties are not free to exclude it: see *CivicLife.com*, at para. 52.

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76 It is true that the Anglo-Canadian common law of contract has been reluctant to impose mandatory rules not based on the agreement of the parties, because they are thought to interfere with freedom of contract: see *Gateway Realty*, *per* Kelly J.; O'Byrne, "Good Faith in Contractual Performance", at p. 95; Farnsworth, at 677-78. As discussed above, however, the duty of honest performance interferes very little with freedom of contract, since parties will rarely expect that their contracts permit dishonest performance of their obligations.

77 That said, I would not rule out any role for the agreement of the parties in influencing the scope of honest performance in a particular context. The precise content of honest performance will vary with context and the parties should be free in some contexts to relax the requirements of the doctrine so long as they respect its minimum core requirements. The approach I outline here is similar in principle to that in § 1-302(b) of the U.C.C. (2012):

> The obligations of good faith, diligence, reasonableness and care ... may not be disclaimed by agreement. The parties, by agreement, may determine the standards by which the performance of those obligations is to be measured if those standards are not manifestly unreasonable.

78 Certainly, any modification of the duty of honest performance would need to be in express terms. A generically worded entire agreement clause such as cl. 11.2 of the Agreement does not indicate any intention of the parties to depart from the basic tenets of honest performance: see *GEC Marconi Systems Pty Ltd. v. BHP Information Technology Pty Ltd.*, [2003] FCA 50 (Australia C.A.) (AustLII), at para. 922, *per* Finn J.; see also O'Byrne, "Good Faith in Contractual Performance", at p. 96.

79 Two arguments are typically raised against an increased role for a duty of good faith in the law of contract: see Bridge, Clark, and Peden, "When Common Law Triumphs Equity: the Rise of Good Faith and Reasonableness and the Demise of Unconscionability". The first is that "good faith" is an inherently unclear concept that will permit *ad hoc* judicial moralism to undermine the certainty of commercial transactions. The second is that imposing a duty of good faith is inconsistent with the basic principle of freedom of contract. I do not have to decide here whether or not these points are valid in relation to a broad, generalized duty of good faith. However, they carry no weight in relation to adopting a rule of honest performance.

80 Recognizing a duty of honesty in contract performance poses no risk to commercial certainty in the law of contract. A reasonable commercial person would expect, at least, that the other party to a contract would not be dishonest about his or her performance. The duty is also clear and easy to apply. Moreover, one commentator points out that given the uncertainty that has prevailed in this area, cautious solicitors have long advised clients to take account of the requirements of good faith: W. Grover, "A Solicitor Looks at Good Faith in Commercial Transactions", in *Special Lectures of the Law Society of Upper Canada 1985 — Commercial Law: Recent Developments and Emerging Trends* (1985), 93, at pp. 106-7. A rule of honest performance in my view will promote, not detract from, certainty in commercial dealings.

81 Any interference by the duty of honest performance with freedom of contract is more theoretical than real. It will surely be rare that parties would wish to agree that they may be dishonest with each other in performing their contractual obligations.

82 Those who fear that this modest step would create uncertainty or impede freedom of contract may take comfort from experience of the civil law of Quebec and the common and statute law of many jurisdictions in the United States.

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83 The *Civil Code of Québec* recognizes a broad duty of good faith which extends to the formation, performance and termination of a contract and includes the notion of the abuse of contractual rights: see arts. 6, 7 and 1375. While this is not the place to expound in detail on good faith in the Quebec civil law, it is worth noting that good faith is seen as having two main aspects. The first is the subjective aspect, which is concerned with the state of mind of the actor, and addresses conduct that is, for example, malicious or intentional. The second is the objective aspect which is concerned with whether conduct is unacceptable according to the standards of reasonable people. As J.-L. Baudouin and P.-G. Jobin explain, [TRANSLATION] "a person can be in good faith (in the subjective sense), that is, act without malicious intent or without knowledge of certain facts, yet his or her conduct may nevertheless be contrary to the requirements of good faith in that it violates objective standards of conduct that are generally accepted in society": *Les obligations* (7th ed. 2013), by P.-G. Jobin and N. Vézina, at para. 132. The notion of good faith includes (but is not limited to) the requirement of honesty in performing the contract: *ibid.*, at para. 161; *Banque de Montréal c. Ng*, [1989] 2 S.C.R. 429 (S.C.C.), at p. 436.

84 In the United States, § 1-304 of the U.C.C. provides that "[e]very contract or duty within the Uniform Commercial Code imposes an obligation of good faith in its performance and enforcement." The U.C.C. has been enacted by legislation in all 50 states. While the provisions of the U.C.C. apply only to commercial contracts, § 205 of the *Restatement (Second) of Contracts* (1981) provides for a general duty of good faith in all contracts. This provision of the *Restatement* has been followed by courts in the vast majority of states. The notion of "good faith" in the *Restatement* substantially followed the definition proposed by Robert Summers in an influential article, where he proposed that "good faith" is best understood as an "excluder" of various categories of bad faith conduct: p. 206; see § 205, comment a. The general definition of "good faith" in the U.C.C. is also quite broad, encompassing honesty and adherence to "reasonable commercial standards": § 1-201(b)(20). This definition was originally limited to "honesty in fact", that is, a duty of honesty in performance, and was only later expanded: A. D. Miller and R. Perry, "Good Faith Performance" (2013), 98 *Iowa L. Rev.* 689, at pp. 719-20. Honesty in performance is also a key component of "good faith" under the *Restatement*: § 205, comments a and d.

85 Experience in Quebec and the United States shows that even very broad conceptions of the duty of good faith have not impeded contractual activity or contractual stability: see, e.g., J. Pineau, "La discrétion judiciaire a-t-elle fait des ravages en matière contractuelle?", in *La réforme du Code civil, cinq ans plus tard* (1998), 141. It is also worth noting that in both the United States and Quebec, judicial developments preceded legislative action in codifying good faith. In the United States, courts had recognized the existence of a general duty of good faith before the promulgation of the U.C.C.: see, e.g., *Kirke La Shelle Co. v. Armstrong Co.* (1933), 263 N.Y. 79 (U.S. N.Y. Ct. App. 1933). Similarly, though there was no express provision of "good faith" in the *Civil Code of Lower Canada*, the Court implied such a general duty from more specific provisions of the *Code*: see *Banque canadienne nationale c. Soucisse*, [1981] 2 S.C.R. 339 (S.C.C.); *Banque nationale du Canada c. Houle*, [1990] 3 S.C.R. 122 (S.C.C.); *Québec (Commission hydroélectrique) c. Banque de Montréal*, [1992] 2 S.C.R. 554 (S.C.C.). The duty of good faith was subsequently included in the revisions leading to the enactment of the *Civil Code of Québec*.

86 The duty of honest performance that I propose should not be confused with a duty of disclosure or of fiduciary loyalty. A party to a contract has no general duty to subordinate his or her interest to that of the other party. However, contracting parties must be able to rely on a minimum standard of honesty from their contracting partner in relation to performing the contract as a reassurance that if the contract does not work out, they will have a fair opportunity to protect their interests. That said, a dealership agreement is not a contract of utmost good faith (*uberrimae fidei*) such as an insurance contract, which among other things obliges the parties to disclose material facts: *Whiten*. But a clear distinction can be drawn between a failure to disclose a material fact, even a firm intention to end the contractual arrangement, and active dishonesty.

87 This distinction explains the result reached by the court in *United Roasters Inc. v. Colgate-Palmolive Co.*, 649 F.2d 985 (U.S. C.A. 4th Cir. 1981). The terminating party had decided in advance of the required notice period that it was going to terminate the contract. The court held that no disclosure of this intention was required other than what was stipulated in the notice requirement. The court stated:

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> ... there is very little to be said in favor of a rule of law that good faith requires one possessing a right of termination to inform the other party promptly of any decision to exercise the right. A tenant under a month-to-month lease may decide in January to vacate the premises at the end of September. It is hardly to be suggested that good faith requires the tenant to inform the landlord of his decision soon after January. Though the landlord may have found earlier notice convenient, formal exercise of the right of termination in August will do. [pp. 989-90]

*United Roasters* makes it clear that there is no unilateral duty to disclose information relevant to termination. But the situation is quite different, as I see it, when it comes to actively misleading or deceiving the other contracting party in relation to performance of the contract.

88 The duty of honest performance has similarities with the existing law in relation to civil fraud and estoppel, but it is not subsumed by them. Unlike promissory estoppel and estoppel by representation, the contractual duty of honest performance does not require that the defendant intend that his or her representation be relied on and it is not subject to the uncertainty around whether estoppel can be used to found an independent cause of action: *Ryan v. Moore*, 2005 SCC 38, [2005] 2 S.C.R. 53 (S.C.C.), at para. 5; *Maracle v. Travelers Indemnity Co. of Canada*, [1991] 2 S.C.R. 50 (S.C.C.); Waddams, *The Law of Contracts*, at paras. 195-203; B. MacDougall, *Estoppel* (2012), at pp. 142-44. As for the tort of civil fraud, breach of the duty of honest contractual performance does not require the defendant to intend that the false statement be relied on and breach of it supports a claim for damages according to the contractual rather than the tortious measure: see, e.g., *Parna v. G. & S. Properties Ltd.* (1970), [1971] S.C.R. 306 (S.C.C.), cited with approval in *Combined Air Mechanical Services Inc. v. Flesch*, 2014 SCC 8, [2014] 1 S.C.R. 126 (S.C.C.), at para. 19.

89 Mr. Bhasin, supported b many judicial and academic authorities, has argued for wholesale adoption of a more expansive duty of good faith in contrast to the modest, incremental change that I propose: A.F., at para. 51; Summers, at p. 206; Belobaba; *Gateway Realty*. In many of its manifestations, good faith requires more than honesty on the part of a contracting party. For example, in *Dynamic Transport*, this Court held that good faith in the context of that contract required a party to take reasonable steps to obtain the planning permission that was a condition precedent to a sale of property. In other cases, the courts have required that discretionary powers not be exercised in a manner that is "capricious" or "arbitrary": *Mason, at p. 487*; *LeMesurier v. Andrus* (1986), 54 O.R. (2d) 1 (Ont. C.A.), at p. 7. In other contexts, this Court has been reluctant to extend the requirements of good faith beyond honesty for fear of causing undue judicial interference in contracts: *Wallace*, at para. 76.

90 It is not necessary in this case to define in general terms the limits of the implications of the organizing principle of good faith. This is because it is unclear to me how any broader duty would assist Mr. Bhasin here. After all, the contract was subject to non-renewal. It is a considerable stretch, as I see it, to turn even a broadly conceived duty of good faith exercise of the non-renewal provision into what is, in effect, a contract of indefinite duration. This in my view is the principal difficulty in the trial judge's reasoning because, in the result, her decision turned a three year contract that was subject to an express provision relating to non-renewal into a contract of roughly nine years' duration. As the Court of Appeal pointed out, in my view correctly, "[t]he parties did not intend or presume a perpetual contract, as they contracted that either party could unilaterally cause it to expire on any third anniversary": para. 32. Even if there were a breach of a broader duty of good faith by forcing the merger, Can-Am's contractual liability would still have to be measured by reference to the least onerous means of performance, which in this case would have meant simply not renewing the contract. Since no damages flow from this breach, it is unnecessary to decide whether reliance on a discretionary power to achieve a purpose extraneous to the contract and which undermined one of its key objectives might call for further development under the organizing principle of good faith contractual performance.

91 I note as well that, even in jurisdictions that embrace a broader role for the duty of good faith, plaintiffs have met with only mixed success in alleging bad faith failure to renew a contract. Some cases have treated non-renewal as equivalent to termination and thus subject to a duty of good faith: *Shell Oil Co. v. Marinello*, 294 A.2d 253 (U.S. N.J. Sup. Ct. 1972), aff'd,

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07 A.2d 598 (U.S. N.J. Sup. Ct. 1973); *Atlantic Richfield Co. v. Razumic*, 390 A.2d 736 (U.S. Pa. S.C. 1978), at pp. 741-42. Other courts have seen non-renewal as fundamentally different, especially where the express terms of the contract contemplate the expiry of contractual obligations and leave no room for any sort of duty to renew: *J.H. Westerbeke Corp. v. Onan Corp.*, 580 F. Supp. 1173 (U.S. Dist. Ct. D. Mass. 1984), at p. 1184; *Pitney-Bowes Inc. v. Mestre* (1981), 517 F. Supp. 52 (U.S. Dist. Ct. S.D. Fla. 1981), cert. denied, 464 U.S. 893 (U.S. Sup. Ct. 1983).

92 I conclude that at this point in the development of Canadian common law, adding a general duty of honest contractual performance is an appropriate incremental step, recognizing that the implications of the broader, organizing principle of good faith must be allowed to evolve according to the same incremental judicial approach.

93 A summary of the principles is in order:

(1) There is a general organizing principle of good faith that underlies many facets of contract law.

(2) In general, the particular implications of the broad principle for particular cases are determined by resorting to the body of doctrine that has developed which gives effect to aspects of that principle in particular types of situations and relationships.

(3) It is appropriate to recognize a new common law duty that applies to all contracts as a manifestation of the general organizing principle of good faith: a duty of honest performance, which requires the parties to be honest with each other in relation to the performance of their contractual obligations.

*(3) Application*

94 The trial judge made a clear finding of fact that Can-Am "acted dishonestly toward Bhasin in exercising the non-renewal clause": para. 261; see also para. 271. There is no basis to interfere with that finding on appeal. It follows that Can-Am breached its duty to perform the Agreement honestly.

95 The immediate dispute in this case centred on the non-renewal clause contained in cl. 3.3 of the 1998 Agreement which Mr. Bhasin entered into in November 1998. It provided that the Agreement was for a three-year term and would be automatically renewed unless one of the parties gave notice to the contrary at least six months before the end of the initial or any renewed term:

> 3.3 The term of this Agreement shall be for a period of three years from the date hereof (the "Initial Term") and thereafter shall be automatically renewed for successive three year periods (a "Renewal Term"), subject to earlier termination as provided for in section 8 hereof, unless either [Can-Am] or the Enrollment Director notifies the other in writing at least six months prior to expiry of the Initial Term or any Renewal Term that the notifying party desires expiry of the Agreement, in which event the Agreement shall expire at the end of such Initial Term or Renewal Term, as applicable.

96 The factual matrix in which the judge made her finding of dishonest performance is complicated and I will only outline it in very broad terms in order to put that finding in context. There were two main interrelated story lines.

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97 The first concerns Mr. Hrynew's persistent attempts to take over Mr. Bhasin's market through a merger — in effect a takeover by him of Mr. Bhasin's agency. The second concerns the difficulties, beginning in early April 1999, that Can-Am was having with the Alberta Securities Commission, which regulated its business and its enrollment directors in Alberta. The Commission insisted that Can-Am appoint a full-time employee to be a PTO responsible for compliance with Alberta securities law. Can-Am ultimately appointed Mr. Hrynew, with the result that he would audit his competitor agencies, including Mr. Bhasin's, and therefore have access to their confidential business information. Mr. Bhasin's refusal to allow Mr. Hrynew access to this information led to the final confrontation with Can-Am and its giving notice of non-renewal in May 2001. Can-Am, for its part, wanted to force a merger of the Bhasin agency under the Hrynew agency, effectively giving Mr. Bhasin's business to Mr. Hrynew. It was in the context of this situation that the trial judge made her findings of dishonesty on the part of Can-Am.

98 The trial judge concluded that Can-Am acted dishonestly with Mr. Bhasin throughout the period leading up to its exercise of the non-renewal clause, both with respect to its own intentions and with respect to Mr. Hrynew's role as PTO. Her detailed findings amply support this overall conclusion.

99 By early 2000, Can-Am was considering a significant reorganization of its activities in Alberta; by June of that year, it sent an organizational chart to the Commission showing that Mr. Bhasin's agency was to be merged under Mr. Hrynew's. But it had said nothing of this to Mr. Bhasin: trial reasons, at paras. 167-68. The trial judge found that these representations made by Can-Am to the Commission were clearly false if, as she concluded, they intended to refer to Mr. Bhasin: para. 246. She also found that Can-Am, by June 2000, was fearful that the Commission was going to pull its licence in Alberta and that it was prepared to do whatever it could to forestall that possibility. "However, it was not dealing honestly with [Mr.] Bhasin about the realities of the situation as [it] saw them": para. 246.

100 In August 2000, Mr. Bhasin first heard of Can-Am's merger plans for him during a meeting with Can-Am's regional vice-president. But when questioned about Can-Am's intentions with respect to the merger, the official "equivocated" and did not tell him the truth that from Can-Am's perspective this was a "done deal". The trial judge concluded that the official was "not honest with [Mr.] Bhasin" at that meeting: para. 247.

101 When Mr. Bhasin complained about Mr. Hrynew's conflict of interest in being both auditor and competitor, Can-Am in effect blamed the Commission, claiming that the Commission had rejected its proposal to appoint a third party PTO. This was not truthful. Can-Am failed to mention that it had proposed to appoint a non-resident of Alberta who was clearly not qualified according to the Commission's criteria or that it had decided to appoint Mr. Hrynew even though he did not meet the Commission's criteria either: trial reasons, at paras. 195 and 221. It also misrepresented — repeatedly — to Mr. Bhasin that Mr. Hrynew was bound by duties of confidentiality and segregation of activities in the course of an audit, when in fact there was no such requirement. Can-Am did not even finalize its PTO contract with Mr. Hrynew until March 2001 and, notwithstanding its assurances to Mr. Bhasin, it failed to include such a provision in the contract: paras. 190-221. As the trial judge found, Can-Am "could not possibly have missed this honestly in the PTO agreement, given that [Mr. Bhasin's] very protests about [Mr.] Hrynew's appointment as PTO were about confidentiality and segregation of activities": para. 221. The judge also found that Can-Am repeated these "lies" about Mr. Hrynew's supposed obligations of confidentiality even after the PTO agreement, without these protections, had been signed: para. 204.

102 Can-Am pushed on with the requirement that Mr. Hrynew audit Mr. Bhasin's agency as if it were required to do so by the Commission even though it had arranged to have one of its employees conduct the audit of Mr. Hrynew's agency: trial reasons, at para. 198.

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103 As the trial judge found, this dishonesty on the part of Can-Am was directly and intimately connected to Can-Am's performance of the Agreement with Mr. Bhasin and its exercise of the non-renewal provision. I conclude that Can-Am breached the 1998 Agreement when it failed to act honestly with Mr. Bhasin in exercising the non-renewal clause.

*C. Liability for Civil Conspiracy and Inducing Breach of Contract*

104 In light of this conclusion, I agree with the Court of Appeal's rejection of Mr. Bhasin's claims based on the torts of inducing breach of contract and unlawful means conspiracy.

105 The trial judge specifically found that Mr. Hrynew did not encourage Can-Am to act dishonestly in its dealings with Mr. Bhasin and that Can-Am's dishonest conduct was not fairly attributable to Mr. Hrynew: paras. 271 and 287. It follows that Mr. Hrynew did not induce Can-Am's breach of its contractual duty of honest performance.

106 The trial judge dismissed the claim for conspiracy to injure and there is no basis to interfere with that finding. However, the trial judge held the respondents liable for unlawful means conspiracy, with the unlawful means being the breach of contract and inducing breach of contract: para. 326. Because, in light of my conclusions, the only relevant breach of contract in this case is the breach of the duty of honest performance and there was no inducement of breach of contract, the only relevant unlawful means pertained to Can-Am alone and not Mr. Hrynew. Accordingly, there can be no liability for civil conspiracy: see *Agribrands Purina Canada Inc. v. Kasamekas*, 2011 ONCA 460, 106 O.R. (3d) 427 (Ont. C.A.), at para. 43.

107 I therefore agree with the result reached by the Court of Appeal that there could be no liability for inducing breach of contract or unlawful means conspiracy: para. 36. It follows that the claims against Mr. Hrynew were rightly dismissed.

***D. What Is the Appropriate Measure of Damages?***

108 I have concluded that Can-Am's breach of contract consisted of its failure to be honest with Mr. Bhasin about its contractual performance and, in particular, with respect to its settled intentions with respect to renewal. It is therefore liable for damages calculated on the basis of what Mr. Bhasin's economic position would have been had Can-Am fulfilled that duty. While the trial judge did not assess damages on that basis given her different findings in relation to liability, she made findings that permit this Court to do so.

109 The trial judge specifically held that but for Can-Am's dishonesty, Mr. Bhasin could have acted so as to "retain the value in his agency": paras. 258-59. In reaching this conclusion, the trial judge was well aware of the difficulties that Mr. Bhasin would have in selling his business given the "almost absolute controls" that Can-Am had on enrollment directors and that it owned the "book of business": para. 402. She also heard evidence and made findings about what the value of the business was, taking these limitations into account. These findings, in my view, permit us to assess damages on the basis that if Can-Am had performed the contract honestly, Mr. Bhasin would have been able to retain the value of his business rather than see it, in effect, expropriated and turned over to Mr. Hrynew.

110 It is clear from the findings of the trial judge and from the record that the value of the business around the time of non-renewal was $87,000. The defendant's expert at trial valued Mr. Bhasin's business as of 2001 (the time of non-renewal) as

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approximately $87,000. While there is some confusion in the record about the date of evaluation and the relevance of discount rates, I am persuaded that the trial judge found that the business was worth $87,000 at the time that the Agreement expired and that she made this finding fully alive to the difficulties standing in the way of a sale of the business given the contractual arrangements between Can-Am and its enrollment directors: see, e.g., para. 451. In addition, we have had no suggestion in argument that this figure should be reassessed. In fact, the defendants, as appellants before the Court of Appeal, submitted to that court that if damages were payable, they should be assessed at the value of the business at the time of the expiry of the Agreement and noted that the trial judge had accepted the evidence of their expert witness, Mr. Bailey, that the value was $87,000.

111 I conclude therefore that Mr. Bhasin is entitled to damages in the amount of $87,000.

**IV. Disposition**

112 I would allow the appeal with respect to Can-Am and dismiss the appeal with respect to Mr. Hrynew. I would vary the trial judge's assessment of damages to $87,000 plus interest. Mr. Bhasin should have his costs throughout as against Can-Am. There should be no costs at any level in favour of or against Mr. Hrynew.

*Appeal allowed in part.*

*Pourvoi accueilli en partie.*

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# TAB 13

2007 ONCA 322
Ontario Court of Appeal

Drouillard v. Cogeco Cable Inc.

2007 CarswellOnt 2624, 2007 ONCA 322, [2007] O.J. No. 1664, 157 A.C.W.S. (3d) 213, 2007 C.L.L.C. 210-034, 223 O.A.C. 350, 282 D.L.R. (4th) 644, 48 C.C.L.T. (3d) 119, 57 C.C.E.L. (3d) 14, 86 O.R. (3d) 431

# Kevin Drouillard (Respondent / Appellant by Cross-Appeal) and Cogeco Cable Inc. (Appellant / Respondent by Cross-Appeal)

D. O'Connor A.C.J.O., K. Feldman, P. Rouleau JJ.A.

Heard: January 26, 2007
Judgment: May 1, 2007 * **
Docket: CA C44042

Proceedings: reversing in part *Drouillard v. Cogeco Cable Inc.* (2005), 2005 C.L.L.C. 210-040, 42 C.C.E.L. (3d) 222, 2005 CarswellOnt 3257 (Ont. S.C.J.)

Counsel: Adrian Miedema for Appellant
Raymond Colautti, Anita Landry for Respondent

Subject: Torts; Employment; Contracts; Civil Practice and Procedure; Evidence; Corporate and Commercial

**Headnote**

**Torts --- Interference with contractual relations — Elements of tort — Miscellaneous**

Plaintiff worked for C Inc. for approximately 15 years until he resigned in December 1999 to work outside Canada — C Inc. held virtual monopoly on cable television and fibre optic businesses in region where plaintiff lived — Plaintiff later returned to region and was offered employment with M Canada to work on project which involved internet upgrades for C Inc. — After C Inc. advised M Canada that it did not want plaintiff working on its equipment, M Canada withdrew its offer of employment to plaintiff — In May 2001, plaintiff was again hired by M Canada but was terminated for same reason almost immediately after starting work — Plaintiff brought successful action for damages in tort against C Inc. — Trial judge found that elements of tort of unlawful interference with economic relations had been made out, and awarded damages to plaintiff — C Inc. appealed, alleging that tort of unlawful interference with economic relations had not been made out because C Inc.'s interference was not by illegal or unlawful means — Appeal dismissed as to liability — In his liability analysis, trial judge seemed to have conflated torts of unlawful interference with economic relations and inducing breach of contract — C Inc. was still liable to plaintiff for damages in tort as C Inc. had committed tort of inducing breach of contract — Trial judge erred in concluding that breach by C Inc. of what appeared to be unwritten internal policy amounted to unlawful act — Nothing in record suggested that C Inc. or its employees were not at liberty to act contrary to internal policy or that M Canada or plaintiff had relied on policy in question such that they could require C Inc. to respect it — It would be inappropriate to extend application of tort of unlawful interference with economic relations to breaches of corporation's internal policies in circumstances of present case — Appeal allowed in part on other grounds.

**Torts --- Inducing breach of contract — Elements of tort**

Plaintiff worked for C Inc. for approximately 15 years until he resigned in December 1999 to work outside Canada — C Inc. held virtual monopoly on cable television and fibre optic businesses in region where plaintiff lived — Plaintiff later returned to region and was offered employment with M Canada to work on project which involved internet upgrades for C Inc. — After C Inc. advised M Canada that it did not want plaintiff working on its equipment, M Canada withdrew its offer


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of employment to plaintiff — In May 2001, plaintiff was again hired by M Canada but was terminated for same reason almost immediately after starting work — Plaintiff brought successful action for damages against C Inc. — Trial judge found that elements of tort of unlawful interference with economic relations had been made out, and awarded damages to plaintiff — C Inc. appealed, alleging that tort of unlawful interference with economic relations had not been made out because C Inc.'s interference was not by illegal or unlawful means — Appeal dismissed as to liability — In his liability analysis, trial judge seemed to have conflated torts of unlawful interference with economic relations and inducing breach of contract — C Inc. was liable in tort to plaintiff for inducing breach of contract — Four elements of tort of inducing breach of contract had been made out, and circumstances did not suggest that defence of justification was open to C Inc. — Plaintiff had valid and enforceable employment contract with M Canada, which satisfied first element of tort — C Inc. was aware of contract between plaintiff and M Canada, satisfying second element of tort — Findings of trial judge amply supported conclusion that C Inc. intended to, and did, procure breach of plaintiff's employment contract, which satisfied third element of tort — It was apparent that trial judge concluded that plaintiff suffered damages, which satisfied fourth element of tort — Appeal allowed in part on other grounds.

**Remedies --- Damages — Damages in tort — Other torts — Miscellaneous**

Inducing breach of contract — Plaintiff worked for C Inc. for approximately 15 years until he resigned in December 1999 to work outside Canada — C Inc. held virtual monopoly on cable television and fibre optic businesses in region where plaintiff lived — Plaintiff later returned to region and was offered employment with M Canada to work on project which involved internet upgrades for C Inc. — After C Inc. advised M Canada that it did not want plaintiff working on its equipment, M Canada withdrew its offer of employment to plaintiff — In May 2001, plaintiff was again hired by M Canada but was terminated for same reason almost immediately after starting work — Plaintiff brought successful action for damages in tort against C Inc. — Trial judge found that elements of tort of unlawful interference with economic relations had been made out and awarded past lost income award of $137,535 and non-pecuniary, or "at large", damages of $62,465 to plaintiff — On appeal, C Inc. alleged that tort of unlawful interference with economic relations had not been made out because C Inc.'s interference was not by illegal or unlawful means — Appeal was dismissed as to liability on basis that, although elements of tort of unlawful interference with economic relations had not been made out, C Inc. was still liable in tort to plaintiff for inducing breach of contract — C Inc. appealed amount of damages awarded to plaintiff — Appeal allowed in this respect — Plaintiff conceded that $92,455.23 earned by him should properly be considered as mitigation, so this figure should be applied to reduce lost income figure as determined by trial judge — Lost income figure was reduced to $45,079.77 — There was no basis to interfere with trial judge's finding that plaintiff suffered loss of income — Trial judge's approach took into account likelihood that plaintiff would have had to endure periods where he was on layoff or underemployed — There was no error in trial judge's setting of "at large" damages amount — There was no basis for setting aside trial judge's finding that case for future loss of income had not been made out — Appeal allowed in part.

**Civil practice and procedure --- Practice on appeal — Powers and duties of appellate court — Evidence on appeal — New evidence**

**Remedies --- Damages — Exemplary, punitive and aggravated damages — Miscellaneous**

## Table of Authorities

**Cases considered by *P. Rouleau J.A.*:**

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*Fasson Canada Inc. v. Mediacoat Inc.* (1996), 1996 CarswellOnt 3716 (Ont. C.A.) — referred to

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*Posluns v. Toronto Stock Exchange* (1968), [1968] 1 S.C.R. 330, 1968 CarswellOnt 68, 67 D.L.R. (2d) 165 (S.C.C.) — referred to

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*Torquay Hotel Co. v. Cousins* (1968), [1969] 2 Ch. 106, [1969] 1 All E.R. 522, [1969] 2 W.L.R. 289 (Eng. C.A.) — considered

*Waxman v. Waxman* (2004), 2004 CarswellOnt 1715, 44 B.L.R. (3d) 165, 186 O.A.C. 201 (Ont. C.A.) — referred to

*Waxman v. Waxman* (2007), 2007 CarswellOnt 988, 2007 CarswellOnt 989 (S.C.C.) — referred to

**Words and phrases considered:**

**Unlawful means**

Although there remains some uncertainty about how broadly the expression "unlawful interference" should be interpreted, it is accepted that the commission of an intentional tort constitutes unlawful means.

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APPEAL by defendant C Inc. from judgment reported at *Drouillard v. Cogeco Cable Inc.* (2005), 2005 C.L.L.C. 210-040, 42 C.C.E.L. (3d) 222, 2005 CarswellOnt 3257 (Ont. S.C.J.), awarding damages to plaintiff in tort.

***P. Rouleau J.A.*:**

1 In February 2001, Drouillard received an employment offer from Mastec Canada ("Mastec"), a cable industry contractor, to work on one of Mastec's projects which involved internet upgrades for Cogeco Cable Inc. ("Cogeco") in the Windsor area. Upon being advised by Cogeco that it did not want Drouillard working on any of its equipment, Mastec withdrew its employment offer from Drouillard who was at Mastec's office in anticipation of signing his employment contract. In May 2001, Drouillard was hired by Mastec but was terminated for the same reason almost immediately after starting work.

2 The trial judge found that Cogeco committed the tort of unlawful interference with Drouillard's economic relations and ordered Cogeco to pay $200,000 in damages together with pre-judgment interest and costs. Cogeco has appealed liability, the quantum of damages, and the quantum of costs. Drouillard has cross-appealed seeking punitive damages and damages for future lost income.

3 For the reasons that follow, I would dismiss Cogeco's appeal as to liability but would vary the quantum of the damages award. I would dismiss the cross-appeal. In light of my decision of those issues, I would not decide the appeal as to costs pending the receipt of further submissions or agreement between the parties.

**Facts**

4 Cogeco is a large cable and internet services provider whose territory includes the Windsor area. Drouillard resides in Windsor and is a skilled cable and fibre optic installer. He worked for Cogeco until 1999, when he resigned to take employment in the United States.

5 In 2001, Drouillard returned to the Windsor area where he sought and obtained an employment offer from Mastec, a cable industry contractor that was working on a large upgrade project for Cogeco. He was offered employment with Mastec in February 2001 and told to report for work. Upon arriving at Mastec's offices, Mastec advised him that it could not let him work in Windsor on Cogeco projects. Unless he agreed to commute and work on projects in London or Kitchener he could not have the job. Because of the time and costs involved in commuting, as well as family obligations in the Windsor area, Drouillard was not prepared to accept the alternative assignment and his employment offer was revoked.

6 Drouillard did not understand why he was being prevented from working on Cogeco's equipment. He retained a lawyer who pursued the matter with Cogeco. In May 2001, believing the problems with Cogeco had been resolved, Mastec hired Drouillard. Drouillard's first assignment was on a Cogeco project. Almost immediately after commencing work, his employment was terminated as a result of a call from Cogeco to Mastec. Cogeco advised Mastec that it would not allow Drouillard to work on any of its equipment.

7 Drouillard also sought employment with another Windsor cable industry contractor, Silverline Cable. Due to rumours it had heard about him, Silverline Cable declined to hire him. Unable to secure employment in his field in the Windsor area, Drouillard retrained and was employed as a conductor by Canadian Pacific Railway in February 2004. He worked full-time for Canadian Pacific Railway until about August 2004, at which point he was laid off. He was still on layoff at the time of the trial and was not expected to return to work for Canadian Pacific Railway before 2005.

8 Drouillard sued Mastec for wrongful dismissal and breach of contract and sued Cogeco for a declaration that it had wrongfully and/or tortiously interfered with his employment and for damages. The action against Mastec was settled before trial.

9 The trial judge awarded judgment in favour of Drouillard. He found that Cogeco had engineered Drouillard's termination by Mastec and that its conduct was malicious and punitive. The trial judge rejected Cogeco's evidence wherein Cogeco suggested that it did not want Drouillard working on its equipment because of his attitude and because his presence on Cogeco's site would

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be bad for morale. The trial judge found that Drouillard was a competent and able technician and that there was no reasonable basis for Cogeco's refusal to allow Mastec to assign Drouillard to Cogeco projects.

10 The trial judge also found that the three elements of the tort of unlawful interference with economic relations had been made out. Drouillard established that Cogeco intended to injure him, that Cogeco interfered with his employment by illegal or unlawful means, and that Drouillard suffered economic loss as a result of Cogeco's actions.

11 The trial judge went on to find that due to Cogeco's dominant position in the Windsor area, Drouillard was unable to find employment in his field. He concluded that had Cogeco not prevented him from working for Mastec, Drouillard would have earned $137,535 for the period from February 2001 to February 2004. The trial judge therefore awarded Drouillard this amount for lost income. The trial judge also found that Drouillard had suffered humiliation, embarrassment, loss of reputation, and loss of his chosen career. The trial judge awarded an additional $62,465 for "at large" damages.

**Issues**

12 The issues raised on this appeal and cross-appeal are as follows:

1) Did the trial judge err in finding Cogeco liable to Drouillard in tort?

2) Was the trial judge's assessment of damages correct?

3) Should the trial judge have awarded punitive damages?

4) Did the trial judge err in awarding substantial indemnity costs without providing the parties with an opportunity to make submissions on the appropriate scale of costs?

***1. Did the trial judge err in finding Cogeco liable to Drouillard in tort?***

*a) Introduction*

13 Drouillard's pleadings contain a claim against Mastec for wrongful dismissal and breach of contract and a claim against Cogeco for tortious interference with his employment. The claim against Mastec was settled before trial. The claim against Cogeco proceeded and, although it is not clear from the pleadings, the cause of action appears to have been founded in the torts of unlawful interference with economic relations and inducing breach of contract. In finding Cogeco liable, the trial judge seems to have conflated the two torts in his analysis.

14 Early in his reasons, the trial judge dealt with the tort of unlawful interference with economic relations. He framed the issue as being whether "there has been an unlawful interference with [Drouillard's] contractual and economic relations with Mastec". As he undertook the legal analysis, the trial judge then stated that the heart of Drouillard's claim is the allegation that "Cogeco has wrongfully [1] interfered with [Drouillard's] economic relations in the manner in which it caused his employment contract with Mastec to be rescinded by it on two separate occasions". The trial judge next dealt specifically with the tort of unlawful interference with economic relations identifying the three elements that need to be proven as:

1) Intent to injure Drouillard;

2) Interference with Drouillard's business by illegal or unlawful means; and

3) Drouillard suffered economic loss.

15 The trial judge then reviewed the evidence and concluded that all three elements had been made out. On this appeal, Cogeco has taken issue with the second element, maintaining that its actions were neither illegal nor unlawful. I will address this issue later in these reasons.

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16 Having concluded that the tort of unlawful interference with economic relations was made out, the trial judge addressed the appropriate damages award and appears to have done so on the basis that Cogeco was liable for the tort of inducing breach of contract. Specifically, the trial judge found that Drouillard was entitled to damages as a result of Cogeco's "wrongful act of procuring [the employment contract's] breach" and assessed the damages flowing from the tort of inducing breach of contract.

17 In order to dispose of this appeal, it is necessary to determine whether, considered separately, either of the torts of unlawful interference with economic relations or inducing breach of contract has been made out. Assuming that one or the other has been made out, I will then consider what damages flow from the breach.

*b) Was the trial judge correct in finding that Cogeco unlawfully interfered with Drouillard's economic relations?*

18 Cogeco maintains that the tort of unlawful interference with economic relations has not been made out because Cogeco's interference was not by illegal or unlawful means.

19 Although there remains some uncertainty about how broadly the expression "unlawful interference" should be interpreted, it is accepted that the commission of an intentional tort constitutes unlawful means. This requirement could be satisfied if, for example, Drouillard had established that Cogeco's actions and interference were defamatory. It has also been held by this court in *Reach M.D. Inc. v. Pharmaceutical Manufacturers Assn. of Canada* (2003), 65 O.R. (3d) 30 (Ont. C.A.) at paras. 50-52, that unlawful means also includes acts which the tortfeasor "is not at liberty to commit". In that decision, the court adopted the view of Lord Denning as expressed in *Torquay Hotel Co. v. Cousins* (1968), [1969] 1 All E.R. 522 (Eng. C.A.), at 530, where he stated:

> I must say a word about unlawful means, because that brings in another principle. I have always understood that if one person deliberately interferes with the trade or business of another, and does so by unlawful means, that is, by an act which he is not at liberty to commit, then he is acting unlawfully, even though he does not procure or induce any actual breach of contract. If the means are unlawful, that is enough.

20 In the present case, the trial judge found that Cogeco had an internal policy to the effect that if it wanted to prevent a contractor from using a certain individual on a Cogeco project it could so instruct the contractor if there was reasonable cause to do so. Based on this finding the trial judge then considered whether, applying the test set out in *Reach*, *supra*, Cogeco had been at liberty to act as it did. He concluded as follows:

> In this case, while Cogeco may have had some right to dictate who works on its equipment, it is the way that it went about this that is all wrong. The secret and unsupported evidence that D'Agostini convinced McGuire to act on and which clearly did not pass the smell test of "reasonable cause" (a policy of the company) amounts, in my view to an illegal act or one without legal justification and as such I find that the second element of the tort has been met. I would also add in support of my conclusion on this point that in taking this action against the Plaintiff Cogeco has breached its own corporate policy of not doing so without there being reasonable cause and then failing to investigate this issue.

21 In my view, on the facts of this case, the trial judge erred in concluding that the breach by Cogeco of what appears to be an unwritten internal policy amounts to an unlawful act. Nothing in the record suggests that either Cogeco or its employees were "not at liberty" to act contrary to the company's internal policy or that Mastec or Drouillard had relied on this policy such that they could require that Cogeco respect it.

22 The situation in the present case is quite different from the facts of *Reach*. In *Reach*, the tortfeasor, the Pharmaceutical Manufacturers Association of Canada (the "PMAC") was a voluntary trade association whose powers were set by its membership. The PMAC had a written Code of Marketing Practices (the "Code") which the association administered through one of its committees. The committee made a ruling against Reach M.D. Inc., one of the association's members, which it had no power to make according to the Code. Laskin J.A. held that the PMAC had not been "at liberty to commit" the act because "the Committee acted beyond its jurisdiction" in making a ruling which it "was not authorized to make. Its ruling was beyond its powers": *Reach* at paras. 43, 52, and 53.

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23 *Reach* is readily distinguishable from the facts in this case. In *Reach*, the PMAC's powers were circumscribed to a certain degree by its members and the Code was directed at protecting the interests of its members. In *Reach*, the PMAC's actions were problematic as the association's ruling went beyond the limits of the powers which its members had given it and the ruling adversely affected the interests of a member, Reach M.D. Inc. In the present case, however, Cogeco's unwritten internal policy was not put in place to protect the interests of Drouillard or Mastec. It does not appear that Drouillard or Mastec were aware of or relied on this policy. Further, there was no indication that Cogeco and the employees involved in the decision regarding Drouillard were "not at liberty" to suspend or simply disregard this unwritten policy.

24 Although the limits of this tort have yet to be set, it would be inappropriate, in my view, to extend the application of this tort to breaches of a corporation's internal policies in circumstances such as those found in this case.

25 Drouillard argued that Cogeco's actions were arbitrary and in bad faith and that this provided an alternate basis for a finding of illegal or unlawful conduct. While such conduct is not to be encouraged, I do not consider that such conduct, which can be viewed as distasteful, constitutes on the facts of this case unlawful or illegal means.

*c) Do the findings of the trial judge support a conclusion that Cogeco induced Mastec to breach its employment contract with Drouillard?*

26 I will turn now to the tort of inducing breach of contract. To succeed on this basis, Drouillard must prove the four elements of the tort which are as follows:

1) Drouillard had a valid and enforceable contract with Mastec;

2) Cogeco was aware of the existence of this contract;

3) Cogeco intended to and did procure the breach of the contract; and

4) As a result of the breach, Drouillard suffered damages.

If the four elements of the tort have been made out, I need then to consider whether the defence of justification is available to Cogeco. See *Posluns v. Toronto Stock Exchange*, [1964] 2 O.R. 547 (Ont. H.C.), aff'd (1965), [1966] 1 O.R. 285 (Ont. C.A.), aff'd [1968] 1 S.C.R. 330 (S.C.C.). See also *Waxman v. Waxman* (2004), 186 O.A.C. 201 (Ont. C.A.), leave to appeal to S.C.C. refused, (2007) (S.C.C.).

27 There seems to be no dispute that Drouillard was hired in May 2001 and had a valid and enforceable employment contract with Mastec. The first element of this tort is satisfied.

28 Cogeco acknowledged that it was aware of the contractual relationship between Mastec and Drouillard. Cogeco's awareness satisfies the second element of the tort.

29 To satisfy the third element of the tort, the procurement of the breach must be intended and direct. In Professor Lewis N. Klar's text *Tort Law* (Toronto: Carswell, 2003) at 612, he states:

> In order to succeed, a plaintiff must prove that the defendant intended to procure a breach of contract. In this respect, intention is proven by showing that the defendant acted with the desire to cause a breach of contract, or with the substantial certainty that a breach of contract would result from the defendant's conduct.

See also *Thermo King Corp. v. Provincial Bank of Canada* (1981), 130 D.L.R. (3d) 256 (Ont. C.A.); *Dirassar v. National Trust Co.* (1966), 59 D.L.R. (2d) 452 (B.C. C.A.); *Emerald Construction Co. v. Lowthian*, [1966] 1 W.L.R. 691 (Eng. C.A.), at 704.

30 In John G. Fleming's text *The Law of Torts*, 9th ed. (Sydney: LBC Information Services, 1998) at 761, he notes that to be liable under this tort the defendant must have acted with the "necessary knowledge and intent of procuring a breach of contract,": Fleming continues at 761-62:

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> Merely that the breach was a natural consequence of his conduct is not sufficient: he must have intended it. Not that he need have actually known the precise terms of it or that his object could be accomplished only through its breach. If — turning a blind eye — he went about it regardless of whether it would involve a breach, he will be treated just as if he had knowingly procured it. Indifference is equated with intent.

31 In my view, the findings of the trial judge amply support the conclusion that this third requirement has been met. Because the claim against Mastec for wrongful dismissal and breach of contract had been settled prior to trial, the trial judge did not have to deal with Mastec's liability. Instead, he needed only to be satisfied that Cogeco intended to and did in fact procure a breach of the employment contract.

32 On the question of intent, the trial judge found:

> a) A Cogeco supervisor called Mastec and "suggested, rather ominously, that it would be in Mastec's best interest if Drouillard did not work for it" and that "it was definitely in Mastec's best interest to ensure that Drouillard was not employed there."
>
> b) "Cogeco did indeed have a problem with [Drouillard] being employed by Mastec."
>
> c) "[B]ased on the meddling by [Cogeco employees, Mastec] once again terminated [Drouillard's] employment with Mastec."
>
> d) "[I]t is beyond question but that the actions of Cogeco were directed against [Drouillard] personally."
>
> e) "The primary and only target of Cogeco's actions was [Drouillard]."
>
> f) "[T]he damages to which Drouillard is entitled in tort are not for the breach of his employment contract with Mastec, but for wrongful act of procuring its breach."

33 Although there is no direct evidence that Cogeco wanted Mastec to terminate Drouillard's employment without reasonable notice, it is clear from the trial judge's findings that he was satisfied that Cogeco was not concerned about the terms of Drouillard's termination and that Cogeco acted intending to cause a breach of Drouillard's employment contract, or with substantial certainty that its conduct would result in a breach. In my view, that finding was open to the trial judge and, therefore, the requirement of intent has been met. See *Fasson Canada Inc. v. Mediacoat Inc.*, [1993] O.J. No. 2228 (Ont. Gen. Div.), aff'd (Ont. C.A.).

34 From the jurisprudence, it is not clear whether in order to succeed the plaintiff must show an unequivocal breach of the contract or whether something short of this will suffice. Some authorities suggest that the requirement can be met if the interference results in the contract being terminated in accordance with its terms or if the contract is made more difficult though not impossible to perform. [2] Beyond acknowledging these strands in the case law, I do not find it necessary to further address or resolve these issues in the present case.

35 Although the requirement that the contract be breached is not directly addressed by the trial judge in his reasons, it is apparent when reading his reasons as a whole that he was satisfied that Mastec breached its contract with Drouillard. This logically follows from his specific reference to Drouillard being entitled in tort for damages against Cogeco for the wrongful act of "procuring its breach" and from the fact that throughout his exposition on damages, he refers to the damages as being awarded for the tort of "inducing breach of contract".

36 The record contains little detail concerning the terms of Drouillard's employment agreement with Mastec or of the severance that Drouillard was entitled to receive. It would have been preferable if the trial judge had made findings as to the terms of the agreement and identified which terms were breached and explained the basis for his findings. His failure to do so is, however, understandable given that the claim against Mastec for breach of contract had been settled. There was, therefore, no

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claim for breach of contract. Although a finding that the contract was breached is a necessary element to the tort claim against Cogeco, this finding is clearly implied.

37 From my review of the record, the trial judge's implicit finding that there had been a breach of contract was open to him. Drouillard entered into an employment agreement with Mastec on the understanding that the earlier problems with Cogeco were no longer an impediment to his employment with Mastec. Within hours of commencing his employment he was sent home and within a day or two, was terminated with little or no notice and little or no severance. On this basis alone, the trial judge could reasonably have found a breach.

38 As to the fourth element, it is apparent that the trial judge concluded that Drouillard suffered damages.

39 I turn now to defence of justification. There are certain situations where a defendant can avoid liability by claiming that his actions which induced the breach of a contract were justified. Phillip H. Osborne, *Law of Torts*, 2d ed. (Toronto: Irwin Law, 2003) at 300-302, reviews the defence of justification but asserts there is little useful modern Canadian authority for this principle. Osborne notes, at 300-301, that what authority there is suggests "it has a narrow scope", "that the absence of malice or bad faith is insufficient to establish the defence", and "that a scrupulous consideration must be given to all the surrounding circumstances." Osborne paints with a broad brush certain circumstances — such as protecting the public interest — where inducing a party to breach a contract may be justified and where a defendant may be insulated from attracting liability in tort. See also Lewis N. Klar, *Tort Law*, 3d ed. (Toronto: Carswell, 2003) at 618-20.

40 In this case, the circumstances do not suggest that the defence of justification is open to Cogeco. The trial judge found that Cogeco had meddled with and violated Drouillard's employment agreement with Mastec, had acted contrary to its corporate policy, and that its conduct was malicious and punitive. According to the trial judge, there was also evidence of malice or unfair dealing on the part of Cogeco in acting against Drouillard's attempt to obtain employment with Mastec. Nowhere did the trial judge suggest Cogeco's actions were justified and, on the facts of the case, I see no basis for making such a finding.

41 In conclusion, I am satisfied that Cogeco is liable in tort to Drouillard for inducing breach of contract.

***2. Was the trial judge's assessment of damages correct?***

42 Damages for the tort of inducing breach of contract are "at large". As set out by Lord Hailsham in *Cassell & Co. v. Broome*, [1972] A.C. 1027 (U.K. H.L.), at 1073:

> The expression "at large" should be used in general to cover all cases where awards of damages may include elements for loss of reputation, injured feelings, bad or good conduct by either party, or punishment, and where in consequence no precise limit can be set in extent.

See also *Waxman v. Waxman*, *supra*.

43 In Fleming's *The Law of Torts* at 765, he states that recovery of "at large" damages for inducing breach of contract is "not limited to specific or special damage and may, for example in case of wrongful dismissal, include compensation for the inconvenience and unhappiness caused by a change of job. Neither are damages limited to those recoverable from the contract-breaker; they may include the prospect of continuing employment beyond the contractual period." [Citations omitted.]

44 The trial judge's approach in this case was to consider what Drouillard would have earned from February 2001 to February 2004 had he been able to work for Mastec and then add to this figure damages for losses he considered to be "at large" in the sense that they were in excess of the demonstrated pecuniary loss sustained by Drouillard. The trial judge assessed the pecuniary loss as being $137,535 and the "at large" amount as $62,465 for a total of $200,000. He then determined that, by February 2004, Drouillard had retrained and there should be no award for future loss of income.

45 Cogeco argues that the trial judge erred in finding that Drouillard suffered any damages at all. In the alternative, if he suffered damages, Cogeco submits that the amount of the award is too high because the trial judge did not reduce the lost income by 30% to reflect the likelihood that Drouillard would have undergone periods of unemployment and did not further

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reduce the figure by $92,455.23 in mitigation to account for Drouillard's earnings during 2001, 2002, and 2003. Cogeco also submits that the "at large" award of $62,465 is too high.

46 Drouillard for his part maintains that, subject to his cross-appeal on the failure to award damages for future lost income and punitive damages, the trial judge's assessment of damages should stand. He concedes that his earnings for 2001, 2002, and 2003 ought to have been taken into account as mitigating his loss. Drouillard maintains, however, that the mitigation should have been applied to a much higher lost income figure as the trial judge had erred in his calculation of the lost income figure. According to Drouillard, the amount by which the trial judge underestimated the lost income figure was substantially in excess of the $92,455.23 in mitigation. Although the correct net amount should in fact be greater than the amount calculated by the trial judge, Drouillard is content that the award made by the trial judge stand.

47 Drouillard has also cross-appealed arguing that the trial judge erred by not awarding future lost income. He sought leave to file fresh evidence in support of this position. That evidence shows, among other things, that since the trial Drouillard has been on a lengthy layoff from his position with Canadian Pacific Railway.

48 I will deal with each of these points in the paragraphs that follow.

*a) Did Drouillard prove that he suffered any damage?*

49 As I understand Cogeco's submission on this point, it submits that Drouillard has not met the onus on him to prove that he has suffered damage. The upgrade project for which Mastec hired Drouillard ended in July of 2001 and the availability of work for Drouillard from July 2001 to February 2004 was pure conjecture. Further, Cogeco argues that Drouillard should have accepted Mastec's offer to work in Kitchener or London rather than be terminated.

50 I would reject this ground of appeal. The trial judge correctly noted that Drouillard bore the onus of proving his damages. He also accurately set out Cogeco's position to the effect that Drouillard ought to have accepted the offer of work in London or Kitchener. The trial judge's extensive analysis of the issue of damage makes it clear, however, that he was satisfied that Drouillard had met the burden of proof and had established that he suffered damage.

51 With respect to the potential employment in Kitchener or London, the trial judge noted Drouillard's significant commitments to his children, his disabled spouse, and his aged grandmother and her developmentally challenged son. According to the trial judge, these circumstances meant that from Drouillard's perspective "he is somewhat tied to the Windsor/Essex County area which would make the prospect of him travelling very far in order to carry out employment, somewhat problematic for him and his family members."

52 The trial judge also dealt with Cogeco's submission that the completion of the upgrade project in July 2001 would have had a significant negative impact on Drouillard's employment. The trial judge acknowledged the importance of this fact but found that despite the decrease in available work in the Windsor area, Drouillard would nonetheless have remained employed with Mastec on a full-time basis but with a substantially reduced income level. According to the trial judge, Drouillard would have continued working with Mastec "given his exemplary work record at Cogeco before leaving to work in the United States, his highly developed skills level and the very positive professional and technical regard with which he was held by his Cogeco Managers, not to mention the affection from his fellow employees."

53 I see no basis to interfere with the trial judge's finding that Drouillard suffered a loss of income.

*b) Should the trial judge's $137,535 assessment of lost income be reduced by 30% to reflect the likelihood of Drouillard encountering periods of unemployment?*

54 Cogeco submits that technicians such as Drouillard regularly suffer periods of unemployment. These occur when the large projects they are working on come to an end. They may remain unemployed until the next large project comes along. The appellant points out that the respondent's expert's lost income calculations provided for a 30% reduction to the projected income to account for just such a contingency.

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55 I would reject this ground of appeal. The trial judge provided detailed and comprehensive reasons setting out how he came to his figure. He did not adopt the figures urged on him by the respondent's expert and the fact that the respondent's expert had applied a 30% reduction to a much larger lost income figure is of no consequence. The approach adopted by the trial judge was to estimate the likely annual income of a person in the respondent's situation for the three-year period between February 2001 and February 2004.

56 The trial judge's reasons show that he was keenly aware of the downturn in fibre optic installations after July 2001 and of the reduction in the earning capacity of technicians after that date. In my view, the trial judge's approach took into account the likelihood that Drouillard would have had to endure periods where he was on layoff or underemployed. I do not, therefore, see any basis to apply a 30% reduction as submitted by the appellant.

*c) Is the $62,465 "at large" damages award too high?*

57 Cogeco submits that the "at large" damages award of $62,465 is too high. The trial judge came to this figure in large measure based on his assessment that Drouillard had lost an otherwise promising career as a cable and fibre optic technician. Cogeco maintains that this was an error. Drouillard was at liberty to work in other areas of the province and could work in the Windsor area provided the employer did not service Cogeco's equipment. Cogeco notes that Drouillard did engage in cable installation work for other employers during the 2001 to 2004 period.

58 As set out earlier, damages for the tort of inducing breach of contract are "at large". The trial judge considered Drouillard's situation and determined that he had to and did change careers. Cogeco was the monopoly cable operator in the Windsor area and, for a cable and fibre optic installer, it was difficult if not impossible to find regular employment in the Windsor area without being in a position to work on Cogeco equipment. In my view, there was an adequate factual basis for the finding of the trial judge that Drouillard was required to change his career and that it was unreasonable, in the circumstances, to require that Drouillard move from the Windsor area. I find no error in the trial judge's setting of the "at large" damages amount and would reject this ground of appeal.

*d) Did the trial judge understate the amount that Drouillard could have earned from February 2001 to February 2004 as a cable and fibre optic technician?*

59 As set out in the preceding sections, I consider the trial judge's analysis of Drouillard's lost income to be thorough and correct. He took into account the downturn in the industry as well as the fact that because of Drouillard's exemplary work history and experience Drouillard would have been earning in the upper range of salaries for technicians in the field. Drouillard has not demonstrated a palpable and overriding error in the trial judge's findings in this regard.

*e) Should the $137,535 lost income figure for the period of February 2001 to February 2004 be reduced by the $92,455.23 of income actually earned?*

60 Drouillard concedes that the $92,455.23 earned by him should properly be considered as mitigation. Because I have rejected Drouillard's submission that the trial judge understated the amount that Drouillard could have earned as a cable and fibre optic technician from February 2001 to February 2004, the mitigation figure should be applied to reduce the lost income figure as determined by the trial judge. As a result, I would reduce the lost income figure by $92,455.23 resulting in a net lost income award of $45,079.77. The $62,465 in "at large" damages are to be added to this figure.

*f) Did the trial judge err in not making an award for future lost income?*

61 The trial judge considered Drouillard's claim for future loss of income. Based on the evidence before him, he concluded that he was "not satisfied that a case for future income loss has been made out by the Plaintiff."

62 Drouillard sought to file fresh evidence on this appeal with respect to future lost income. This fresh evidence sets out the layoff patterns for Canadian Pacific Railway and shows that after the trial Drouillard has continued to be layed off from his position at Canadian Pacific Railway.

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63 Cogeco opposes the filing of the fresh evidence. It submits that the information regarding the layoff patterns of Canadian Pacific Railway was available at the time of trial and could have been presented if Drouillard had so chosen. With respect to Drouillard's post-trial layoff situation, Cogeco argues that there is nothing new in this evidence. Drouillard was on layoff at the time of trial and the fresh evidence does no more than show that the situation that existed at trial has continued. Cogeco also submits that this fresh evidence is being tendered to bolster a claim for future loss of income, a claim that was dismissed at trial.

64 Cogeco argues that Drouillard has not established a proper basis for the filing of fresh evidence as set out by this court in *Sengmueller v. Sengmueller* (1994), 17 O.R. (3d) 208 (Ont. C.A.). Even if the evidence were received it would have had no effect on the outcome. The trial judge was well aware of the fact that Drouillard was on layoff and that the layoff would continue for a period. He nonetheless rejected Drouillard's claim for future loss of income.

65 I agree with Cogeco's submissions on this point. In my view, the fresh evidence ought not to be admitted. Further, I see no basis for setting aside the trial judge's finding that a case for future loss of income was not made out.

***3. Should the trial judge have awarded punitive damages?***

66 In his cross-appeal, Drouillard argues that because the trial judge's reasons make no mention of the claim for punitive damages it is apparent that the trial judge simply failed to address whether an award of punitive damages should be made. Drouillard submits that the trial judge made all of the findings necessary to support an award of punitive damages and that this court ought to allow the cross-appeal and award $100,000 in punitive damages.

67 Cogeco submits that a decision on whether to award punitive damages is mostly a factual one and that such awards are only made in exceptional cases. Here, the trial judge elected not to make the award and this court should defer to that decision.

68 I agree that the trial judge's findings of fact could provide the basis of an award of punitive damages. The trial judge found that Cogeco had engineered Drouillard's termination by Mastec and that its conduct was malicious and punitive. The trial judge also found that because of Cogeco's actions Drouillard had suffered humiliation, embarrassment, loss of reputation, and the loss of his chosen career.

69 Although these findings could provide an adequate basis for an award of punitive damages, the trial judge elected not to award them. While it would have been preferable if the trial judge had specifically addressed the issue, I am not satisfied that the failure to award punitive damages was an oversight. The trial judge was well aware of the impact of Cogeco's conduct on Drouillard. He took this conduct into account in assessing the "at large" damages at $62,465. As set out by the trial judge, these "at large" damages took "into account not only the pecuniary, but non-pecuniary damages as well, for the humiliation and loss of reputation and most importantly, the loss of his career he suffered. They should also be reflective of the conduct of the Defendant toward him which in my view was malicious and punitive."

70 In my view, the trial judge exercised his discretion to not award punitive damages in the circumstances and preferred instead to award "at large" damages. This exercise of discretion was reasonable on the facts of this case.

***4. Did the trial judge err in awarding substantial indemnity costs without providing the parties with an opportunity to make submissions on the appropriate scale of costs?***

71 The disposition I propose for the appeal would substantially alter the amount of the judgment. This change may well have an impact on the appropriate award for the costs of the trial. I would, therefore, not decide this issue at this point and would ask the parties to make submissions on the appropriate disposition of the trial costs at the same time as they make submissions on the appropriate costs of the appeal. If the parties are unable to agree on costs, this fourth issue would be dealt with as part of a later decision by this court on costs.

**Disposition**

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72 For these reasons, I would dismiss the motion to file fresh evidence, dismiss the appeal as to liability, but would allow the appeal as to quantum and therefore vary the damages award to $107,544.77. I would dismiss the cross-appeal.

73 If no agreement is reached on costs, I would ask Cogeco to make brief written submissions on the costs of the trial, the appeal, and cross-appeal within fifteen days hereof. Drouillard would then respond within ten days thereafter.

***D. O'Connor A.C.J.O.*:**

I agree.

***K. Feldman J.A.*:**

I agree.

*Appeal allowed in part.*

Footnotes

* Corrigenda issued by the court on June 21, 2007 and June 26, 2007 have been incorporated herein.

** Additional reasons at *Drouillard v. Cogeco Cable Inc.* (2007), 2007 CarswellOnt 4106, 2007 ONCA 485 (Ont. C.A.).

1 The trial judge appears to have used "unlawful" and "wrongful" interchangeably when speaking of the tort of unlawful interference with economic relations.

2 Inducing breach of contract generally requires a contract to be breached. There is, however, Canadian case law citing with approval the British principle that a breach is not necessary for finding a party liable for inducing breach of contract. In *D.E. & J.C. Hutchison Contracting Co. v. Windigo Community Development Corp.*, [1998] O.J. No. 4884 (Ont. Gen. Div.) at para. 30, Kozak J. cited with approval the British principle from *Dimbleby & Sons v. National Union of Journalists* (1983), [1984] 1 W.L.R. 67 (Eng. C.A.): "The doctrine of interference with contractual relations has been extended to include ... where the performance became more difficult though not impossible." There is also English authority suggesting that the mere fact that the party induced had an option to terminate the contract under its terms is of no avail to a defendant who has procured a breach. See *Emerald Construction*, *supra*, but contrast *Cutsforth v. Mansfield Inns Ltd.*, [1986] 1 W.L.R. 558 at 563 Sir Neil Lawson.

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# TAB 14

2008 ONCA 506
Ontario Court of Appeal

Correia v. Canac Kitchens

2008 CarswellOnt 3712, 2008 ONCA 506, [2008] O.J. No. 2497, 167 A.C.W.S. (3d) 422, 2009 C.L.L.C. 210-001, 240 O.A.C. 153, 294 D.L.R. (4th) 525, 58 C.C.L.T. (3d) 29, 67 C.C.E.L. (3d) 1, 91 O.R. (3d) 353

# JOAO CORREIA, MARIA CORREIA, JULIA CORREIA and NATALIA CORREIA (Plaintiffs / Appellants) and CANAC KITCHENS, A DIVISON OF KOHLER LTD., THE ESTATE OF PHIL SUNSTROM, DECEASED, MARILYN SMITH, KOHLER CO., PAUL J. HELSON, ASTON ASSOCIATES INVESTIGATIONS LIMITED, FARSHID DHANJI, GORD OSBORNE, TERESA SPECIALE, YORK REGIONAL POLICE, GORD SMYTH, PAUL CAREY, BRAD LAW, BRYAN SHEA, KERRY VINCENT, MICHAEL GODBER, JOHN DOE, JOHN DOE2, JOHN DOE3 and JOHN DOE4 (Defendants / Respondents)

D. O'Connor A.C.J.O., M. Rosenberg, K. Feldman JJ.A.

Heard: December 20, 2007
Judgment: June 24, 2008 *
Docket: CA C46712

Proceedings: reversed in part *Correia v. Canac Kitchens* ((2007)), 2007 CarswellOnt 232, [2007] O.J. No. 143, 56 C.C.E.L. (3d) 209 ((Ont. S.C.J.)); reversed in part *Correia v. Canac Kitchens* ((January 26, 2007)), Doc. 03-CV-244796CM ((Ont. S.C.J.))

Counsel: Rebecca Nelson for Appellants
J. Murray Davison, Q.C., Matthew Biderman for Respondents, York Regional Police, Gordon Smyth, Paul Carey, Brad Law, Bryan Shea, Kerry Vincent, Michael Godber
Brett Harrison, Lisa Brost for Respondents, Canac Kitchens, Kohler, Marilyn Smith
Lisa La Horey, Laurie Murphy for Respondents, Aston Associates Investigations Ltd., Farshid Dhanji, Gord Osborne, Teresa Speciale

Subject: Torts; Employment; Public; Contracts; Corporate and Commercial; Civil Practice and Procedure

**Headnote**

**Torts --- Miscellaneous**

Negligent investigation — Employer and its parent company ("employers") hired A Ltd. to investigate workplace theft — Due to clerical error by employers, A Ltd.'s report mistakenly identified plaintiff as thief — Plaintiff was discharged and arrested — Plaintiff commenced action against A Ltd. and employers — Plaintiff's negligent investigation claim was summarily dismissed — Plaintiff appealed — Appeal allowed; dismissal set aside in relation to A Ltd. — There was triable issue on prima facie duty of care — Court could conclude that harm was reasonably foreseeable on basis that defendants knew police would rely on their investigation — Factors supporting proximity included that duty of care was owed to particular employee and that plaintiff had critical interests at stake — Policy considerations favoured recognizing duty of care in respect of private investigators ("PIs") retained by employers to investigate crime ("PIs") — PIs were analogous to police and ought to be subject to similar liability — Insufficient remedies were available in wrongful dismissal, malicious prosecution, and negligent investigation by police — Duty of care would not distort legal relationships among employers, employees and PIs — Duty of care has been recognized for police investigators — With respect to employers, recognizing

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duty of care was inconsistent with principle that good faith reasons are not required for dismissal, and might have chilling effect on reporting of criminality.

**Torts --- Negligence — Duty and standard of care — Duty of care**

Negligent investigation — Employer and its parent company ("employers") hired A Ltd. to investigate workplace theft — Due to clerical error by employers, A Ltd.'s report mistakenly identified plaintiff as thief — Plaintiff was discharged and arrested — Plaintiff commenced action against A Ltd. and employers — Plaintiff's negligent investigation claim was summarily dismissed — Plaintiff appealed — Appeal allowed; dismissal set aside in relation to A Ltd. — There was triable issue on prima facie duty of care — Court could conclude that harm was reasonably foreseeable on basis that defendants knew police would rely on their investigation — Factors supporting proximity included that duty of care was owed to particular employee and that plaintiff had critical interests at stake — Policy considerations favoured recognizing duty of care in respect of private investigators ("PIs") retained by employers to investigate crime — PIs were analogous to police and ought to be subject to similar liability — Insufficient remedies were available in wrongful dismissal, malicious prosecution, and negligent investigation by police — Duty of care would not distort legal relationships among employers, employees and PIs — Duty of care has been recognized for police investigators — With respect to employers, recognizing duty of care was inconsistent with principle that good faith reasons are not required for dismissal, and might have chilling effect on reporting of criminality.

**Torts --- Intentional infliction of mental suffering — Elements of tort**

Employer and its parent company hired A Ltd. to investigate workplace theft — Due to clerical error by employer's manager, A Ltd.'s report mistakenly identified plaintiff as thief — Plaintiff was discharged and arrested — Plaintiff commenced action against A Ltd., employers and manager for various torts — Defendants were partly successful on motion for summary judgment with respect to claim for intentional infliction of mental distress — Motions judge dismissed claim except as against employer — Plaintiff appealed and employer cross-appealed — Appeal allowed; cross-appeal dismissed — Claim for intentional infliction of mental distress permitted to proceed against all defendants — Motion judge's reasons implicitly found employer's conduct could meet three-pronged test — Motions judge erred in dismissing claim against manager on ground that she was acting in course of employment — Manager could be held personally liable for her conduct, as it concerned separate actionable tort, not wrongful termination of employment — Motions judge's finding that A Ltd.'s conduct did not meet three-pronged test did not justify granting summary judgment — A Ltd. also faced trial for negligent investigation, and if negligence was found, A Ltd.'s conduct might meet test.

**Labour and employment law --- Employment law — Nature of employment relationship — What constituting acts done in course of employment — Miscellaneous**

Intentional infliction of mental distress — Employer hired A Ltd. to investigate workplace theft — Due to clerical error by employer's manager, A Ltd.'s report mistakenly identified plaintiff as thief — Plaintiff was discharged and arrested — Plaintiff commenced action against A Ltd., employers and manager for various torts — Manager succeeded on motion for summary judgment with respect to claim for intentional infliction of mental distress — Plaintiff appealed — Appeal allowed — Claim for intentional infliction of mental distress permitted to proceed against manager — Motions judge erred in dismissing claim against manager on ground that she was acting in course of employment — Manager could be held personally liable for her conduct, as it concerned separate actionable tort, not wrongful termination of employment.

**Torts --- Interference with contractual relations — Elements of tort — Intention to cause loss**

Employer and its parent company hired A Ltd. to investigate workplace theft — Due to clerical error by employer's manager, A Ltd.'s report mistakenly identified plaintiff as thief — Plaintiff was discharged and arrested — Plaintiff commenced action against A Ltd. and parent company ("defendants") for interference with contractual relations — Defendants succeed on motion for summary judgment — Plaintiff appealed — Appeal dismissed — Plaintiff's claims failed to meet requirement that defendants' conduct was intentional — Neither defendant intended that employer breach its contract of employment with plaintiff — Defendants' intent was not that plaintiff's employment would be wrongfully terminated, but that it would be lawfully terminated for cause.

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**Torts --- Interference with economic relations — Elements of tort — Intention to cause loss**

Employer and its parent company hired A Ltd. to investigate workplace theft — Due to clerical error by employer's manager, A Ltd.'s report mistakenly identified plaintiff as thief — Plaintiff was discharged and arrested — Plaintiff commenced action against A Ltd. and parent company ("defendants") for interference with economic relations — Defendants succeed on motion for summary judgment — Plaintiff appealed — Appeal dismissed — Plaintiff's claims failed to meet requirement that defendants' conduct was intentional — Neither defendant intended to cause harm to plaintiff by conducting negligent investigation — Defendant's conduct was at most was negligent — To extent that defendants were reckless as to consequences of their negligent conduct, this did not amount to intention to cause harm sufficient to make out tort.

**Civil practice and procedure --- Summary judgment — Requirement to show no triable issue**

Intentional infliction of mental distress — Employer and its parent company hired A Ltd. to investigate workplace theft — Due to clerical error by employer's manager, A Ltd.'s report mistakenly identified plaintiff as thief — Plaintiff was discharged and arrested — Plaintiff commenced action against A Ltd., employers and manager for various torts — Defendants were partly successful on motion for summary judgment with respect to claim for intentional infliction of mental distress — Motions judge dismissed claim except as against employer — Plaintiff appealed and employer cross-appealed — Appeal allowed; cross-appeal dismissed — Claim for intentional infliction of mental distress permitted to proceed against all defendants — Motion judge's reasons implicitly found employer's conduct could meet three-pronged test — Motions judge erred in dismissing claim against manager on ground that she was acting in course of employment — Manager could be held personally liable for her conduct, as it concerned separate actionable tort, not wrongful termination of employment — Motions judge's finding that A Ltd.'s conduct did not meet three-pronged test did not justify granting summary judgment — A Ltd. also faced trial for negligent investigation, and if negligence was found, A Ltd.'s conduct might meet test.

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*Alper Development Inc. v. Harrowston Corp.* (1998), 107 O.A.C. 318, 1998 CarswellOnt 1205, 36 C.C.E.L. (2d) 173, 38 O.R. (3d) 785 (Ont. C.A.) — referred to

*Anns v. Merton London Borough Council* (1977), (sub nom. *Anns v. London Borough of Merton)* [1977] 2 All E.R. 492, [1978] A.C. 728, [1977] 2 W.L.R. 1024, 121 S.J. 377 (U.K. H.L.) — followed

*Bank Leu AG v. Gaming Lottery Corp.* (2001), 2001 CarswellOnt 4262, 29 B.L.R. (3d) 68 (Ont. S.C.J. [Commercial List]) — referred to

*Bank Leu AG v. Gaming Lottery Corp.* (2003), 2003 CarswellOnt 3103, 175 O.A.C. 143, 37 B.L.R. (3d) 1, 231 D.L.R. (4th) 251 (Ont. C.A.) — referred to

*BMG Canada Inc. v. Antek Madison Plastics Recycling Corp.* (2006), 2006 CarswellOnt 8663 (Ont. S.C.J.) — considered

*BMG Canada Inc. v. Antek Madison Plastics Recycling Corp.* (2006), 2006 CarswellOnt 7206 (Ont. C.A.) — distinguished

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*Cooper v. Hobart* (2001), [2002] 1 W.W.R. 221, 2001 CarswellBC 2502, 2001 CarswellBC 2503, 2001 SCC 79, 8 C.C.L.T. (3d) 26, 206 D.L.R. (4th) 193, 96 B.C.L.R. (3d) 36, (sub nom. *Cooper v. Registrar of Mortgage Brokers (B.C.))* 277 N.R. 113, [2001] 3 S.C.R. 537, (sub nom. *Cooper v. Registrar of Mortgage Brokers (B.C.))* 160 B.C.A.C. 268, (sub nom. *Cooper v. Registrar of Mortgage Brokers (B.C.))* 261 W.A.C. 268 (S.C.C.) — considered

*Elliott v. Insurance Crime Prevention Bureau* (2005), 2005 NSCA 115, 2005 CarswellNS 353, 256 D.L.R. (4th) 674, 236 N.S.R. (2d) 104, 749 A.P.R. 104, 26 C.C.L.I. (4th) 1 (N.S. C.A.) — distinguished

*Hill v. Hamilton-Wentworth (Regional Municipality) Police Services Board* (2007), 2007 SCC 41, 2007 CarswellOnt 6265, 2007 CarswellOnt 6266, 87 O.R. (3d) 397 (note), 40 M.P.L.R. (4th) 1, 64 Admin. L.R. (4th) 163, 50 C.C.L.T. (3d) 1, 368 N.R. 1, 285 D.L.R. (4th) 620, [2007] 3 S.C.R. 129, 50 C.R. (6th) 279, 230 O.A.C. 260 (S.C.C.) — followed

*Keays v. Honda Canada Inc.* (2006), 2006 CarswellOnt 5885, 216 O.A.C. 3, 82 O.R. (3d) 161, 274 D.L.R. (4th) 107, 2006 C.L.L.C. 230-030, 52 C.C.E.L. (3d) 165 (Ont. C.A.) — referred to

*Keays v. Honda Canada Inc.* (2007), 2007 CarswellOnt 1874, 2007 CarswellOnt 1875, 233 O.A.C. 397 (note), 368 N.R. 393 (note) (S.C.C.) — referred to

*Keays v. Honda Canada Inc.* (2008), 2008 SCC 39, 2008 CarswellOnt 3743, 2008 CarswellOnt 3744 (S.C.C.) — referred to

*London Drugs Ltd. v. Kuehne & Nagel International Ltd.* (1992), [1993] 1 W.W.R. 1, [1992] 3 S.C.R. 299, (sub nom. *London Drugs Ltd. v. Brassart)* 143 N.R. 1, 73 B.C.L.R. (2d) 1, 43 C.C.E.L. 1, 13 C.C.L.T. (2d) 1, (sub nom. *London Drugs Ltd. v. Brassart)* 18 B.C.A.C. 1, (sub nom. *London Drugs Ltd. v. Brassart)* 31 W.A.C. 1, 97 D.L.R. (4th) 261, 1992 CarswellBC 913, 1992 CarswellBC 315 (S.C.C.) — referred to

*Lumley v. Gye* (1853), 118 E.R. 749, 2 El. & Bl. 216, 17 Jur. 827, 22 L.J.Q.B. 463 (Eng. Q.B.) — considered

*Meditrust Healthcare Inc. v. Shoppers Drug Mart* (1999), 124 O.A.C. 137, 1999 CarswellOnt 2762 (Ont. C.A.) — referred to

*Mirra v. Toronto Dominion Bank* (2004), 2004 CarswellOnt 1716 (Ont. S.C.J.) — referred to

*Nielsen v. Kamloops (City)* (1984), [1984] 5 W.W.R. 1, 1984 CarswellBC 476, 66 B.C.L.R. 273, [1984] 2 S.C.R. 2, 10 D.L.R. (4th) 641, 54 N.R. 1, 11 Admin. L.R. 1, 29 C.C.L.T. 97, 8 C.L.R. 1, 26 M.P.L.R. 81, 1984 CarswellBC 821 (S.C.C.) — followed

*OBG Ltd. v. Allan* (2007), [2007] 19 E.G. 165, [2007] E.M.L.R. 12, [2007] I.R.L.R. 608, [2007] Bus. L.R. 1600, [2008] 1 A.C. 1, [2008] 1 All E.R. (Comm) 1, [2007] 4 All E.R. 545, [2007] 2 W.L.R. 920 (U.K. H.L.) — considered

*Prinzo v. Baycrest Centre for Geriatric Care* (2002), 2002 CarswellOnt 2263, 161 O.A.C. 302, 60 O.R. (3d) 474, 2002 C.L.L.C. 210-027, 17 C.C.E.L. (3d) 207, 215 D.L.R. (4th) 31 (Ont. C.A.) — considered

*Rahemtulla v. Vanfed Credit Union* (1984), [1984] 3 W.W.R. 296, 51 B.C.L.R. 200, 29 C.C.L.T. 78, 1984 CarswellBC 36, 4 C.C.E.L. 170 (B.C. S.C.) — considered

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*Said v. Butt* (1920), [1920] All E.R. Rep. 232, 90 L.J.K.B. 239, 124 L.T. 413, [1920] 3 K.B. 497 (Eng. K.B.) — distinguished

*South Pacific Manufacturing Co. v. New Zealand Security Consultants & Investigations* (1991), [1992] 2 N.Z.L.R. 282 (New Zealand C.A.) — referred to

*Tarleton v. McGawley* (1794), 1 Peake 270 (Eng. K.B.) — referred to

*Wallace v. United Grain Growers Ltd.* (1997), 123 Man. R. (2d) 1, 159 W.A.C. 1, 152 D.L.R. (4th) 1, 1997 CarswellMan 455, 1997 CarswellMan 456, 219 N.R. 161, [1997] 3 S.C.R. 701, [1999] 4 W.W.R. 86, 36 C.C.E.L. (2d) 1, 3 C.B.R. (4th) 1, [1997] L.V.I. 2889-1, 97 C.L.L.C. 210-029 (S.C.C.) — considered

*Whiten v. Pilot Insurance Co.* (2002), 156 O.A.C. 201, 35 C.C.L.I. (3d) 1, [2002] 1 S.C.R. 595, 2002 SCC 18, 2002 CarswellOnt 537, 2002 CarswellOnt 538, 283 N.R. 1, 20 B.L.R. (3d) 165, [2002] I.L.R. I-4048, 209 D.L.R. (4th) 257 (S.C.C.) — considered

**Statutes considered:**

*Canadian Charter of Rights and Freedoms*, Part I of the Constitution Act, 1982, being Schedule B to the Canada Act 1982 (U.K.), 1982, c. 11

Generally — referred to

**Words and phrases considered:**

**inducing breach of contract**

The Lords defined the elements of the tort of inducing breach of contract as follows: (1) the defendant had knowledge of the contract between the plaintiff and the third party; (2) the defendant's conduct was intended to cause the third party to breach the contract; (3) the defendant's conduct caused the third party to breach the contract; (4) the plaintiff suffered damage as a result of the breach (see [*OBG Ltd. v. Allan*, [2007] UKHL 21 (U.K. H.L.)] at paras. 39-44 (Hoffman L.)). The Lords confined the tort to cases where the defendant actually knew that its conduct would cause the third party to breach (it is not enough that the defendant ought reasonably to have known that its conduct would cause the third party to breach); the defendant must have intended the breach (it is not enough that a breach was merely a foreseeable consequence of the defendant's conduct); and there must be an actual breach (it is not enough for the conduct to merely hinder full performance of the contract).

**causing loss by unlawful means**

The elements of the tort of causing loss by unlawful means are: (1) wrongful interference by the defendant with the actions of a third party in which the plaintiff has an economic interest; (2) an intention by the defendant to cause loss to the plaintiff: see [*OBG Ltd. v. Allan*, [2007] UKHL 21 (U.K. H.L.)] at para. 47 (Hoffman L.). Again, the intentionality of the defendant's conduct is critical: it is not enough that the loss was a foreseeable consequence of the defendant's conduct; to be actionable under this tort, the loss must have been the intended result. Furthermore, intentional conduct that causes loss but is not unlawful, is not actionable. That is considered permissible competitive commercial behaviour.

APPEAL by plaintiff from decision of motion for summary judgment reported at *Correia v. Canac Kitchens* (2007), 2007 CarswellOnt 232, 56 C.C.E.L. (3d) 209 (Ont. S.C.J.), dismissing some of his claims arising from private investigation by employer resulting in dismissal; CROSS-APPEAL by defendants.

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***M. Rosenberg, K. Feldman JJ.A.*:**

1 This appeal from the decision of Low J. granting partial summary judgment dismissing a number of aspects of the fired employee's claim, concerns the legal implications when an employer embarks on an investigation of the criminal conduct of its employees.

2 In 2002, Joao Correia's employer Canac Kitchens and its parent company Kohler Ltd. suspected that there was theft and drug dealing occurring at the Canac plant. They therefore retained a private investigation firm to conduct an investigation. The firm placed an undercover agent in the firm and he identified several employees engaged in theft and drug dealing. The firm kept the local police force apprised of the investigation, but the police force did little if any independent investigation.

3 On October 24, 2002 Mr. Correia, a long-time employee aged sixty-two years, was brought into his employer's human resources office, accused of theft and fired for cause. He was then taken to another office and arrested by police officers for theft. The only problem is that Mr. Correia was innocent. Through a series of mistakes, he was confused with another employee with a similar name but who was almost forty years younger. Eventually, the mistake was discovered, but by then Mr. Correia claims to have suffered serious injury.

4 Mr. Correia and his family sued his employer, the parent company, the private investigation firm, the police force and several individuals. The plaintiffs claim damages under various causes of action. On summary judgment motions brought by all the defendants except the police defendants, the motions judge dismissed several of those causes of action including claims for negligent investigation, malicious prosecution, false arrest, intentional infliction of mental distress, inducing breach of contract and intentional interference with contractual relations.

5 For the following reasons we would allow the appeal in part and in particular set aside the dismissal of the claim for negligent investigation against the private investigation firm and for intentional infliction of mental distress against Kohler and Marilyn Smith and the Aston defendants.

**The Facts**

6 It may be helpful to begin by identifying and providing a short description of the various persons involved in the case.

| | |
|---|---|
| 1. **Canac Kitchens** | The employer |
| 2. Marilyn Smith | Head of Human Resources at Canac |
| 3. **Kohler** | Canac's parent company |
| 4. Phil Sunstrom [now deceased] | Head of Security at Kohler |
| 5. **Aston** | Private investigation firm retained by Kohler to conduct an investigation at Canac |
| 6. Teresa Speciale | Part owner of Aston and in charge of this investigation for Aston |
| 7. Farshid Dhanji | Employee of Aston and undercover agent placed at Canac |
| 8. **York Regional Police** | Made the arrests |
| 9. Bryan Shea | Drug squad officer became involved to handle any drugs obtained by Dhanji |
| 10. Paul Carey | Officer with Criminal Investigations Branch, became involved to effect arrests of employees involved in theft |

7 Canac is a manufacturing company and a subsidiary of a United States company, Kohler. Canac employs over 800 people at its facility. By 2002, Canac was having a serious problem with theft and drug dealing at its plant. With the assistance of Kohler, Canac decided to attempt to identify the employees involved and dismiss them. Kohler retained Aston to conduct an investigation. In June 2002, Canac added Fashid Dhanji, an employee of Aston, to its payroll and he was put on the factory

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floor. Because Aston anticipated that Dhanji would come in contact with illegal drugs it contacted the York Regional Police to obtain advice about handling the drugs.

8 In addition to Dhanji's undercover work, Aston set up surveillance in the plant that was carried out by other persons. The sequence of events that led to misidentification of Mr. Correia is summarized in the following chronology:

| | |
|---|---|
| September 17, 2002 | Report from Aston describing a theft suspect as "Joe Portuguese 5'11" ... 180 lbs, mid 20's". |
| September 23, 2002 | Report refers to "Joel". |
| October 1, 2002 | Report refers to "Joao Corriero" [note the plaintiff's name is Joao Correia]. |
| October 7, 2002 | Smith of Canac prepares "Authorized Corporate Transaction" seeking Kohler's approval to dismiss ten employees including "J. Correia Supvr" [This is the first time the plaintiff's name is mentioned. The real suspect turns out to be Joao Corriero.] Smith claims she asked Phil Sunstrom of Kohler to check her work. Kohler approved the dismissals. |
| October 15, 2002 | Report from Aston includes a surveillance tape of Corriero and a photocopy of his identification badge. |
| October 15, 2002 | The police meet with Aston representative Speciale to discuss the arrests. Speciale provided the police with a suspect's list. The first list includes the name Corriero. The police ask for further details of identification. |
| October 22, 2002 | The police again meet with Aston representative Speciale and with Sunstrom. The suspect is now identified as "Joao Correia", *i.e.* the plaintiff, with his date of birth of June 7, 1940. |
| October 24, 2002 | The final meeting with the police takes place and the final suspect list includes the plaintiff's name. Speciale and Sunstrom are present at the meeting. |

9 The plaintiff's arrest and dismissal took place later on October 24. Sunstrom of Kohler first took the plaintiff to Smith's office where she gave him a termination letter. Sunstrom then took the plaintiff to another office at the Canac premises where he was arrested. Although the police had asked that Dhanji be present at the arrests, Aston refused. No one showed Dhanji pictures of the employees to be dismissed, although pictures of all employees were in the Canac files.

10 The plaintiff spent about three hours in jail before being released. Four months later the Crown dropped the charge after the plaintiff's counsel was able to demonstrate the mistake. Canac offered to reinstate the plaintiff but he was too devastated to return to employment.

11 As the motions judge observed at paras. 25-27 of her comprehensive reasons, had Smith or Speciale taken the time to carefully read the Aston investigative reports it would have been apparent that the twenty-something year old suspect was not the plaintiff, a sixty-two year old long time employee whose name is spelt differently.

12 Staff Sergeant Carey reviewed Aston's reports and formed the view that there were grounds to arrest the plaintiff. The police carried out no other independent investigation. The police deny that they were provided with any surveillance videotapes, identification badges or photographs of the suspects.

**The Claims**

13 The motions judge disposed of the various claims as follows:

| | |
|---|---|
| (1) **Negligent investigation**: all defendants | • Motions judge allowed motion for summary judgment by all of the defendants except the police defendants, who did not move for summary judgment. — • The plaintiffs appeal against this disposition. |
| (2) **Intentional infliction of mental distress**: Canac, Marilyn Smith, Kohler, Aston, and Aston's employees | • Motions judge dismissed motion for summary judgment by Canac but allowed the motion by Marilyn Smith and the Aston defendants. She did not expressly deal with Kohler. — • Canac |

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| | |
|---|---|
| | cross-appeals this disposition; the plaintiffs appeal in relation to Marilyn Smith, Kohler and the Aston defendants. |
| (3) **Intentional interference with economic relations and inducing breach of contract**: Aston and Kohler defendants (including individuals) | • Motions judge allowed motion for summary judgment by all defendants. — • The plaintiffs appeal against this disposition. |
| (4) **False arrest and false imprisonment:** all defendants | • Motions judge allowed motion for summary judgment by all of the defendants, except the police defendants who did not move for summary judgment. — • The plaintiffs do not appeal against this disposition. |
| (5) **Malicious prosecution:** all defendants | • Motions judge allowed motion for summary judgment by all of the defendants, except the police defendants who did not move for summary judgment. — • The plaintiffs do not appeal against this disposition. |
| (6) **Vicarious liability** | • Motions judge found Kohler not bound by Phil Sunstrom's deemed admissions. The plaintiff appeals the effect of this finding. |

14 The plaintiffs also claimed against Canac for wrongful dismissal. Canac did not seek summary judgment on that claim.

**Analysis**

***A. Negligent Investigation***

*(a) The Reasons of the Motions Judge*

15 The motions judge found that the plaintiff did not stand in a relationship with any of the moving defendants (*i.e.* everyone except the police defendants) which could fall within a category or in a position analogous to an established category in which a duty of care has been recognized. She held that the plaintiff was a stranger to Aston and to all of the individual defendants. While he had a contract of employment with Canac, that did not create a duty of care contemplated by the claim. An employer has a right to terminate employment and the fact that "in coming to its decision the employer acted on misinformation negligently gathered does not augment the employee's rights; nor is the employer's obligation diminished if it acts without negligence". In the absence of a duty of care, no action for negligent investigation lies.

16 The motions judge particularly relied upon the reasons of this court in *BMG Canada Inc. v. Antek Madison Plastics Recycling Corp.*, [2006] O.J. No. 4577 (Ont. C.A.) where it was held that no duty of care existed because of lack of foreseeability. As she said at para. 53:

> In my view, the same reasoning and considerations apply in the case at bar as in *BMG*. Notwithstanding that Aston and Canac represented to the police that they would arrange for the right persons to be available for arrest as suspects, it is nevertheless not foreseeable that the police would undertake no investigation of their own in circumstances where the information they were receiving by way of the Aston reports was a compilation of second and third hand hearsay. There was neither obligation nor practical compulsion to make the arrests on October 24 as opposed to some later date. There was no impediment to the police doing its own checking with the actual witnesses (the undercover and the videographer) and no impediment to the police reviewing the videotape of the theft occurrence before proceeding with the arrest.

17 The motions judge further held that there were compelling reasons to not impose a duty of care on private actors, as opposed to the police. She was concerned that to impose tort liability would have a chilling effect on the willingness of citizens to report criminal behaviour and she saw no reason to distinguish in this regard between "amateur" informants and professionals like Aston. She was also of the view that adequate alternative remedies exist such as an action in defamation and, in this case, an action for wrongful dismissal.

*(b) Analysis of the Negligent Investigation Claims*

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18 In *Hill v. Hamilton-Wentworth (Regional Municipality) Police Services Board*, [2007] 3 S.C.R. 129 (S.C.C.), the Supreme Court of Canada recognized the tort of negligent investigation as applied to police officers. Speaking for the majority, McLachlin C.J.C. held that the police owe a duty of care in negligence to suspects being investigated. The question posed by this case is whether the reasoning in *Hill* can be extended to recognize a duty of care on private actors.

19 The test for determining whether a person owes a duty of care to another as laid down in *Anns v. Merton London Borough Council* (1977), [1978] A.C. 728 (U.K. H.L.) has been accepted by the Supreme Court of Canada in a number of decisions including *Nielsen v. Kamloops (City)*, [1984] 2 S.C.R. 2 (S.C.C.). The test involves two questions:

> (1) Does the relationship between the plaintiff and the defendant disclose sufficient foreseeability and proximity to establish a *prima facie* duty of care?
>
> (2) Are there any policy considerations that should nevertheless negate or limit that duty of care?

**(1) Foreseeability and Proximity**

20 The motions judge found against the appellants in this case on the issue of foreseeability, relying on this court's decision in *BMG*. *BMG* concerned a motion to strike a counterclaim as disclosing no cause of action. The motion was therefore dealt with on the basis of the allegations in the Statement of Counterclaim. The claim of negligent investigation against BMG was brought by the defendant James Angelopoulos, who was a director and officer of the defendant Antek. The claim of negligent investigation arose out of the prosecution of Angelopoulos based on information supplied to the police by *BMG*.

21 While there is a superficial similarity between this case and *BMG*, there are critical differences. The relevant allegations by Angelopoulos in the counterclaim were as follows:

> 44. In June 2000, BMG on its own and through its agents, commenced an investigation into misappropriation and fraud which they alleged, without having completed an investigation, were perpetrated by Angelopoulos.
>
> 45. BMG contacted the York Regional Police to report an allegation of fraud committed upon BMG by Angelopoulos and Antek. BMG's report was based on incomplete, inaccurate and misleading information.
>
> 46. BMG provided to the York Regional Police various memos, notes and statements that were compiled by BMG and/or its investigative delegate.
>
> 47. On or about September 19, 2000, George Skrba was in police custody having been found in possession of BMG product. Skrba provided a statement to the police, which he knew was false. He made this statement for the purpose of misleading the police to cause them to prosecute criminal charges against Angelopoulos and not himself. Skrba's false statement was motivated by his attempt to secure his own release from custody and to avoid criminal charges and prosecution.
>
> 48. Skrba told the police that he knew Angelopoulos, he did business with Angelopoulos and he purchased compact discs from Angelopoulos. All of these assertions were false.

22 Sachs J., in reasons reported at [*BMG Canada Inc. v. Antek Madison Plastics Recycling Corp.*] 2006 CarswellOnt 8663 (Ont. S.C.J.), held that it was plain and obvious that the claim could not succeed. She applied the reasoning of the Nova Scotia Court of Appeal in *Elliott v. Insurance Crime Prevention Bureau* (2005), 236 N.S.R. (2d) 104 (N.S. C.A.), which we will discuss below, and found that there was not a sufficiently proximate relationship and that, in any event, a duty of care should not be recognized for policy reasons.

23 On appeal, this court, in a brief endorsement, dismissed the appeal solely on the basis of lack of foreseeability. The court's reasons are found in paras. 2-3:

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> For the police to arrest someone, they are, as a matter of law, required to determine for themselves that reasonable and probable grounds exist to do so.
>
> In our view it cannot be said to be reasonably foreseeable that *the police would take the information supplied to them by the respondent, however false or sloppily prepared, and proceed to charge the appellant without doing the job required of them by law*. [Emphasis added.]

24 In our view, this court was not laying down as a matter of law that in no case where a party provides information to the police can it be said that the requisite foreseeability does not exist. The authorities make it clear that reasonable foreseeability depends upon the circumstances and the context; the court looks at the relationship between the plaintiff and the defendant. As McLachlin C.J.C. said in *Hill*, the first question is "whether it was reasonably foreseeable that the actions of the alleged wrongdoer would cause harm to the victim". In *BMG Canada Inc.*, the alleged wrongdoer had conducted an incomplete investigation which was supplemented by information from a person in police custody. *BMG Canada Inc.* was not "in the business" of conducting investigations and did not have any special expertise in doing so. In those circumstances, it was not foreseeable that the police would not conduct a proper investigation.

25 This case, in our view, is different from *BMG*. Aston together with Canac and Kohler did a complete investigation. They gathered all of the information of the criminal offences and handed a completed case to the police. To the knowledge of Aston, Canac and Kohler, the police were not intending to do any further investigation. To the contrary, the identified employees were to be dismissed and then immediately turned over to the police who were on the Canac property for arrest. It would be open to a trier of fact to find that to the knowledge of the defendants, the police had limited, if any, ability to conduct a further investigation. Aston had decided not to make the undercover employee available at the time of the arrests. Again, a trier of fact could find that Canac, Kohler and Aston had to have known that the police would rely completely on their investigation. It may be that the police should have done more; that will be an issue to be determined at trial. After a trial, however, a court could conclude that it was reasonably foreseeable in the circumstances existing here that negligence by Aston, Canac and Kohler in identifying the real perpetrator of the crime would cause harm to Mr. Correia.

26 The second element of the first part of the *Anns/Kamloops* test to establish a *prima facie* duty of care is whether there is a close and direct relationship of proximity or neighbourhood. In *Hill* at para. 24, McLachlin C.J.C. explains that the proximity relationship requires consideration of factors such as "expectations, representations, reliance and property or other interests involved". In *Hill*, McLachlin C.J.C. was careful to point out that a very particular relationship was involved, namely the relationship between a police officer and a specific suspect whom the officer is investigating. She was not suggesting that the proximity element is made out in respect to every person with whom the police come in contact.

27 Similarly, in considering the proximity element in this case, it is important to consider the nature of the particular relationship. This case does not involve all persons who may provide information to the police or be investigated by the authorities. It involves the duty of care owed by an employer to its employee and the duty of care owed by a professional investigator, hired by that employer, to a particular employee.

28 In *Hill* at para. 29, McLachlin C.J.C. stated that the "most basic factor upon which the proximity analysis fixes" is whether there is a "close and direct" relationship. She described the nature of this relationship in these terms:

> This factor is not concerned with how intimate the plaintiff and defendant were or with their physical proximity, so much as with whether the *actions* of the alleged wrongdoer have a close or direct effect on the victim, such that the wrongdoer ought to have had the victim in mind as a person potentially harmed. A sufficiently close and direct connection between the actions of the wrongdoer and the victim may exist where there is a personal relationship between alleged wrongdoer and victim. However, it may also exist where there is no personal relationship between the victim and wrongdoer.
>
> [Emphasis in original.]

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29 In *Hill*, McLachlin C.J.C. found that the relationship between the plaintiff and the police was personal, close and direct. The police had identified the plaintiff as a particularized suspect in a series of robberies and had begun to investigate him. This created a close and direct relationship. Another consideration was the interests engaged. In *Hill* at para. 34, McLachlin C.J.C. found that even though there were no personal representations and consequent reliance, the plaintiff had a critical personal interest in the conduct of the investigation:

> At stake are his freedom, his reputation and how he may spend a good portion of his life. These high interests support a finding of a proximate relationship giving rise to a duty of care.

The same may be said here: the plaintiff had similar high interests at stake.

30 McLachlin C.J.C. also took into consideration several other factors in dealing with the proximity analysis. She noted that existing remedies for wrongful prosecution such as false arrest, false imprisonment and malicious prosecution do not provide an adequate remedy for negligent acts. The same considerations apply in this case. The motions judge dismissed the claim of false arrest against the Canac, Kohler and Aston defendants because of the absence of evidence of a total deprivation of Mr. Correia's liberty, and no evidence that the police could not exercise their independent discretion. The claim of malicious prosecution was likewise dismissed as there was no basis in the evidence for a finding of malice.

31 The respondents submit, however, that the contractual remedy of wrongful dismissal including the availability of *Wallace* damages (*Wallace v. United Grain Growers Ltd.*, [1997] 3 S.C.R. 701 (S.C.C.)) and punitive damages provide adequate remedies. The appellants produced evidence of the serious consequences to Mr. Correia flowing from the dismissal and arrest, including major depressive disorder and symptoms of post-traumatic stress disorder, to the point where he may never be able to work again. The appellants argue that damages for wrongful dismissal would not fully compensate for injuries, such as loss of future income, that the appellants submit flow from the negligent investigation. We agree with that submission. [1] *Wallace* damages could add to the length of the notice period and provide some compensation for the manner in which the appellant was terminated but may not fully compensate for the losses suffered by Mr. Correia and his family in this type of case.

32 Similarly, the objective of punitive damages "is to punish the defendant rather than compensate a plaintiff (whose just compensation will already have been assessed)": *Whiten v. Pilot Insurance Co.*, [2002] 1 S.C.R. 595 (S.C.C.) at p. 617. Since the purpose of punitive damages is not to compensate, there can be no assurance that even if awarded they would, together with damages for wrongful dismissal, fully compensate the plaintiff for the alleged negligence. We also note that punitive damages have been relatively modest in wrongful dismissal cases. See *Keays v. Honda Canada Inc.* (2006), 82 O.R. (3d) 161 (Ont. C.A.) at para. 104 [leave to appeal to S.C.C. granted (2007) (S.C.C.); heard and reserved 2008 CarswellOnt 3743 (S.C.C.), by the S.C.C. on February 7, 2008].

33 In *Hill*, McLachlin C.J.C. pointed out that the personal interest of the suspect in the conduct of the investigation is enhanced by a public interest. In that respect, she referred to the role that negligent police investigation has had as a significant contributor to wrongful convictions. She also noted that recognizing a duty of care by police officers to suspects is consistent with the values and spirit underlying the *Charter of Rights and Freedoms*, especially liberty and fair process. All these considerations led her to conclude at para. 39 of *Hill* that "an investigating police officer and a particular suspect are close and proximate such that a *prima facie* duty should be recognized".

34 While these same public interest considerations are either not applicable or do not apply with the same force to recognizing a duty of care in employers and private security companies, we do not understand *Hill* as holding that these broader concerns are prerequisites to recognizing a duty of care. Rather, the question is whether the nature of the particular relationship is such that for policy reasons a duty of care should be recognized. These public interest considerations can be analyzed under the rubric of the second stage of the *Anns/Kamloops* test where the court is concerned with "the effect of recognizing a duty of care on other legal obligations, the legal system and society more generally": *Cooper v. Hobart*, [2001] 3 S.C.R. 537 (S.C.C.) at para. 37. Accordingly, we will discuss these considerations further below.

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35 To conclude, we are satisfied that there exists a triable issue whether the relationship between the plaintiff and the Aston, Kohler and Canac defendants discloses sufficient foreseeability and proximity to establish a *prima facie* duty of care.

**(2) Residual Policy Considerations with Respect to Aston**

36 In the following discussion, we intend to deal first with the policy considerations that apply to Aston. We will then deal separately with Canac and Kohler.

37 In *Cooper* at para. 37, the court suggested a number of questions to be asked in considering whether residual policy considerations tell against recognizing a duty of care:

> Does the law already provide a remedy? Would recognition of the duty of care create the spectre of unlimited liability to an unlimited class? Are there other reasons of broad policy that suggest that the duty of care should not be recognized?

38 We propose to analyze the second stage of the *Anns/Kamloops* test in light of these questions. Before doing so, however, we note that on a policy level, the case for recognizing a duty of care in respect of private investigation firms may be stronger than for the police in several respects. The policy considerations that the defendants put forward in *Hill*, aside from the potential chilling effect on investigation of crime, have no application to the private actors involved in this case. Those policy considerations were advanced by the Attorneys General of Ontario and Canada and various police associations as negating a duty of care, and can be summarized as follows:

- the "quasi-judicial" nature of police work;
- the potential for conflict between a duty of care in negligence and other duties owed by police;
- the need to recognize a significant amount of discretion present in police work;
- the need to maintain the standard of reasonable and probable grounds applicable to police conduct;
- the potential for a chilling effect on the investigation of crime; and
- the possibility of a flood of litigation against the police.

39 Private security firms are not engaged in quasi-judicial work. There is no conflict between a duty of care in negligence and other duties that the private security firm may owe to the public. While the firm may have contractual obligations to the party that has retained it, it is not apparent how those obligations would conflict with a duty of care to the person being investigated. The other policy considerations mentioned such as the impact on police discretion and the standard of reasonable and probable grounds have no application to the potential liability of a private security firm.

40 We therefore turn to the other policy considerations suggested by the motions judge and Aston in this case.

***(i) The Chilling Effect***

41 The motions judge was concerned about the chilling effect of recognizing a duty of care in private security firms and other private citizens. She made the following observations at paras. 55 and 56:

> I would agree also with the court's view in *Elliot*, *supra*, that there are compelling reasons to negative the imposition of a duty of care and I would add to the list of countervailing considerations the public interest in not casting a chill over the willingness of citizens, whether in the business of fact investigation or not, to provide law enforcement authorities with information and cooperation.
>
> It is argued on behalf of the plaintiffs that a duty should be imposed on persons like Aston who are in the business of gathering information even if no duty is imposed on "amateur" informants — that is, ordinary citizens. In this regard, I see

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> no valid reason to draw a distinction between "amateur" informants and persons who are in the business of fact gathering. There is a built-in inhibition against carelessness on the part of the professional fact gatherer in that his livelihood depends on the reliability of the information he provides to his client; he stands to lose credibility, clientele, and the ability to stay in business should his sloppiness cause his clients loss or embarrassment. Professional fact gatherers are not, however, the only persons who experience such a built-in deterrent to carelessness — the same deterrent applies to a panoply of professional and other persons who have a vested interest in maintaining their credibility in the community, and it is fallacious to conflate reliability qua information source, which is a function of ability, with duty, which is a function of proximity.

42 In *Hill*, McLachlin C.J.C. pointed out at para. 48 that "policy concerns raised against imposing a duty of care must be more than speculative; a real potential for negative consequences must be apparent".

43 The motions judge was concerned about a chilling effect from recognizing a duty of care, and that even professional investigators like Aston would be less willing to provide law enforcement authorities with information or cooperate with the police. In our view, this is too speculative. There is no empirical evidence to support this suggestion; the Aston defendants provided no information about their relationship with the police or how it would be affected if a duty of care were recognized. There is a good argument that the potential disadvantage from curbing the flow of information between the private security firm and the police would be substantially outweighed by the advantage of encouraging greater care. To apply what McLachlin C.J.C. said in *Hill* at para. 56 to this case, it is conceivable that the private firm might become more careful in the kinds of information that they pass on to the police but "this is not necessarily a bad thing".

44 Private investigation firms occupy an increasingly important role in society. As the Law Commission of Canada said in its discussion paper *In Search of Security: The Roles of Public Police and Private Agencies* (Ottawa: Law Commission of Canada, 2002) at p. 5:

> Something quite remarkable has been happening to the organization of policing in Canada over the last 30 years. Many functions that were once the exclusive domain of public police forces are now being performed by private agencies. *In some instances, this means that private security is doing things that the public police used to do*. In other instances, it means that whole new areas of activities — services that did not exist or were not widely available — can now be purchased. [Emphasis added.]

45 This case is an example. It is difficult to imagine that thirty years ago, a private investigation firm would be conducting an investigation into drug dealing, but that is what Aston was doing at Canac. Yet, as the Law Commission points out at p. 11 of the same discussion paper, these firms and their clients operate largely unregulated; certainly they are not obviously governed by the many checks and balances that constrain the public police. Put simply, they can often exercise functionally equivalent powers but without the same constraints:

> Private security officers also have ostensibly considerable authority to deprive individuals of their liberty. Like the public police, private security officers arrest, detain and search individuals on a regular basis. But, for the most part, private security officers do not operate under the same constraints as the public police ... in many facets of their work private security officers are not subject to the *Canadian Charter of Rights and Freedoms*.

46 At pp. 15-16, the discussion paper draws attention to the fact that there is little effective public oversight of private policing and that injured persons have limited avenues of redress: "There exists in Canada a regulatory system for monitoring the performance of the public police. The problem, however, is that there is little effective oversight of private security." Finally at p. 19, the paper points out that the public police and private investigation firms often cooperate; this "contributes to the blurring of the relationship between public and private". Again, this case is an example. The investigation was carried out by Aston, but with the knowledge and cooperation of the York Regional Police.

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47 In our view, the fact that private investigation firms perform public policing functions but with limited oversight or clear lines of redress to those injured by their activities strongly favours extending tort liability. Where, as here, the private firm performs a function analogous to the public police, they ought to be subject to similar liability.

***(ii) Availability of an Alternative Remedy***

48 All of the respondents, but especially the Aston defendants, placed considerable emphasis on the decision of the Nova Scotia Court of Appeal in *Elliott*. *Elliott* was an insurance case. The plaintiffs' home was destroyed by fire. The insurer retained an independent adjusting firm which in turn retained a number of private investigators. The insurer denied coverage on the basis of arson because of the report from the investigators. The plaintiffs sued the insurer and recovered damages to cover the loss. The judge, however, refused to compensate for mental distress and refused to award aggravated and punitive damages because he found that the insurer had not acted in bad faith by denying the claim.

49 The plaintiffs then brought an action against the adjusters and investigators and against the deputy fire marshall. The plaintiffs alleged that the adjusters and investigators were negligent and they sought to recover from them for the injuries that had been left uncompensated in the action against the insurer. The trial judge found that the defendants owed the plaintiffs no duty of care and dismissed the action for that reason, and because of the doctrine of witness immunity.

50 Writing for the court, Cromwell J.A. found that the trial judge erred in respect of witness immunity but that he properly held that the defendants did not owe the plaintiffs any duty of care. The respondents rely upon Cromwell J.A.'s analysis as it relates to the private investigation firms. The questions of witness immunity and liability of the deputy fire marshall are not germane to this appeal.

51 Cromwell J.A. found that the first step of the *Anns/Kamloops* analysis was satisfied; that the adjusters and investigators working for the insurer could foresee that they would create a risk of harm if they were negligent in their investigation and reporting. Particularly relying upon the decision of the New Zealand Court of Appeal in *Mortensen v. Laing*, *South Pacific Manufacturing Co. Ltd. v. New Zealand Security Consultants & Investigations Ltd.* (1991), [1992] 2 N.Z.L.R. 282 (New Zealand C.A.), Cromwell J.A. was satisfied that there was also sufficient proximity. Accordingly, an investigator retained to investigate the cause of loss on behalf of an insurer owed a *prima facie* duty of care. However, the action against the investigators failed at the second stage because of broader policy considerations.

52 Two policy considerations led the *Elliott* court to find against imposing a duty of care on the investigators. They are: (1) the insured had a substantial and meaningful remedy in contract against the insurer; and (2) imposing the duty would distort the legal relationships among the insured, the insurer and the investigators and undermine the ability of the insured and the insurer to properly deal with insurance claims. The respondents in this appeal submit that similar policy considerations tell against imposing a duty of care on the investigator and the employer for negligence. We will consider both of these policy considerations as explained in *Elliott* and explain why, in our view, they do not apply as against the Aston defendants. As indicated, we will deal separately with Canac and Kohler.

53 In *Elliott*, Cromwell J.A. noted that in an action on the insurance contract, not only can the insured recover for the loss, but breach of the duty of good faith can sound in punitive damages as recognized in *Whiten v. Pilot Insurance Co.*, *supra*. Thus, while not all heads of damages may be available in an action on the insurance contract, the availability of a remedy in contract was a significant policy reason not to expand tort liability. As he put it at para. 84, the contractual remedy "is a substantial, if not always complete, alternative remedy which strongly works against the expanded liability in negligence proposed by the appellants".

54 The respondents in this case make much the same argument. They submit that the contractual remedy of wrongful dismissal and the potential suit against the police for malicious prosecution and negligent investigation are sufficient remedies. We disagree. In our view, there are important differences between the nature and scope of the remedies available in the insurance context as compared to the employment context.

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55 We begin with the contractual remedy. The scope of the remedy for wrongful dismissal is described in *Wallace*. The fundamental principle that underlies that remedy is the right of both the employer and the employee to terminate the relationship at will, absent contractual terms to the contrary, subject to the requirement of giving notice or in the case of the employer salary in lieu of notice. In *Wallace*, the court therefore rejected the submission that there exists a requirement of good faith reasons for dismissal, as well as the possibility that there could be an independent action or head of damages for breach of this duty either in contract or in tort. However, the court held, at para. 88, that bad faith conduct in the manner of dismissal is a factor that is properly compensated by an extension of the notice period.

56 There are limits, however, to *Wallace* damages. The only compensation to which the employee is entitled is for loss of salary and benefits during the period of notice that should have been given. The employee is not compensated for the loss of the job, because the employer always had the right to terminate the employee. The employment contract is thus fundamentally different from the insurance contract. The discharged employee may not recover the full extent of his or her actual loss. On the contrary, subject to contractual terms such as a deductible and bargained-for limit on compensation, the insurer is ordinarily required to fully compensate the insured for the actual loss. In our view, therefore, unlike in *Elliott*, the availability of the contractual remedy in the employment context does not tell strongly against expanded liability in negligence. There may be significant additional losses left uncompensated in a wrongful dismissal claim, such as loss of the job or non-pecuniary damages which, as in a case such as this, may be the direct result of the negligent investigation by a private firm that led to the dismissal.

57 As for the availability of actions for malicious prosecution and negligent investigation against the police, there are two answers. First, the fact that an action may lie against one wrongdoer is not generally a basis for relieving another wrongdoer from liability. For one thing, such a state of affairs may be unfair to the other alleged tortfeasors. Second, the court in *Hill* held at para. 35 that the intentional torts such as malicious prosecution "do not provide an adequate remedy for negligent acts". As in *Hill*, recognition of the tort of negligent private investigation would "complete the arsenal of already existing common law and statutory remedies". As to the availability of punitive damages, we have already dealt with that issue in the context of proximity and the first branch of the *Anns/Kamloops* test.

58 For these reasons, we would not place the same weight on the existence of alternative remedies as did the court in *Elliott*.

***(iii) Distortion of Legal Relationships***

59 In *Elliott*, Cromwell J.A. explained the several ways in which recognition of a duty of care on insurance investigators would distort the various legal relationships among the insured, the insurer and the investigators. First, the insured and the investigators have defined their relationships with the insurer contractually. Where contracts cover relationships, public policy favours holding that the contracts control "unless special reasons are shown to warrant a direct suit in tort": *Elliott* at para. 86. Cromwell J.A. concluded that far from there being special reasons warranting expansion of tort liability on insurance investigators, recognition of a duty of care could lead to legal incoherence. The possibility that investigators retained by the insurer could have greater liability to the insured for carelessness than the insurer itself, would set up a scheme inconsistent with the primacy of the insurer's obligation to the insured. Further, such a negligence claim could be used as a means of avoiding the determination of the real issue of what caused the loss as between the insured and the insurer. In his view, this inconsistency should be avoided.

60 We do not share the same concerns in the context of the employer, employee, and investigator relationships. While the primary relationship is between the employer and employee, we see no reason why different or even greater liability cannot be imposed upon the private investigator for its carelessness, which allegedly led to the kind of damages claimed in this case, including post-traumatic stress disorder. Further, recovery of damages from a negligent private investigator would not serve as a means of avoiding determination of the wrongful dismissal claim against the employer, as the kinds of damages available under each cause of action do not overlap.

61 Cromwell J.A. also held that permitting liability would interfere with settled principles in other areas such as the law of defamation and malicious prosecution. As to the former, according to Cromwell J.A., an investigator reporting to its principal

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would generally benefit from a qualified privilege and thus a defamation suit could only succeed upon proof of malice. Similarly, reports of arson not infrequently lead to prosecution but again a suit for malicious prosecution could succeed only upon proof of malice. It seems to us, however, that the decision in *Hill*, which was decided after *Elliott*, tells against this policy consideration. Again, as pointed out earlier, it was the very fact that the plaintiff might be denied compensation because of the inability to prove malice that led McLachlin C.J.C. to favour recognition of liability for negligence.

62 Cromwell J.A. had a second concern with respect to the distortion of legal relationships. He expressed this concern in several ways. First, he saw "a real possibility of conflict between the contractual and the tortious duties which could undermine the ability of the insurer to administer insurance contracts in a cost effective and expeditious manner": *Elliott* at para. 90. A similar argument was made in *Hill* where the defendants argued that recognizing a duty of care to a suspect would interfere with the legitimate exercise of discretion by police and lead to confusion with the respect to the legal standard applicable to police work. McLachlin C.J.C. held that those concerns could be answered by recognizing a "flexible standard of care appropriate to the circumstances": *Hill* at para. 55. She went on to hold that the appropriate standard of care is that of a reasonable police officer in like circumstances: *Hill* at paras. 67-73. Such a standard would give due recognition to the discretion inherent in police investigation.

63 Third, Cromwell J.A. in *Elliott*, at para. 91, was concerned that recognizing a duty of care in the insurance context would be unacceptably indeterminate: "it would be difficult to justify not extending the proposed duty of care to anyone who, in the course of a contractual engagement, carelessly investigates and reports on the conduct of a third party". Again, we think the answer to this particular concern is now found in *Hill* at para. 60:

> Recognizing sufficient proximity in the relationship between police and suspect to ground a duty of care does not open the door to indeterminate liability. *Particularized suspects represent a limited category of potential claimants.* The class of potential claimants is further limited by the requirement that the plaintiff establish compensable injury caused by a negligent investigation. Treatment rightfully imposed by the law does not constitute compensable injury. These considerations undermine the spectre of a glut of jailhouse lawsuits for negligent police investigation. [Emphasis added.]

64 For similar reasons, we are of the view that the spectre of indeterminate liability is not a consideration in this case. The universe of potential claimants is circumscribed first by the necessity of the employment relationship and second by the requirement that the duty is owed by the private investigator or firm to particularized suspects who are being investigated for the employer.

65 Fourth, Cromwell J.A. was concerned about the problem of divided loyalties if the investigator were found to owe a duty of care to the insured and a contractual duty to the insurer. Referring to *Mortensen*, he said at para. 92 that "imposing a duty of care in relation to the insured might inhibit the investigators' ability to discharge their primary duty to the insurer". A similar consideration loomed large in *Hill* and was relied upon by the dissenting members of the court for refusing to recognize a duty of care for negligence albeit on the basis of lack of proximity: see the reasons of Charron J. at paras. 140-48. The argument is that imposing a duty of care to the individual suspect would interfere with the performance of the officer's public duty: see the example posited by Charron J. at para. 141. But McLachlin C.J.C. reached the opposite conclusion at para. 36:

> The personal interest of the suspect in the conduct of the investigation is enhanced by a public interest. Recognizing an action for negligent police investigation may assist in responding to failures of the justice system, such as wrongful convictions or institutional racism. The unfortunate reality is that negligent policing has now been recognized as a significant contributing factor to wrongful convictions in Canada. While the vast majority of police officers perform their duties carefully and reasonably, the record shows that wrongful convictions traceable to faulty police investigations occur. Even one wrongful conviction is too many, and Canada has had more than one. Police conduct that is not malicious, not deliberate, but merely fails to comply with standards of reasonableness can be a significant cause of wrongful convictions.

66 Similar concerns apply to private investigations. As the private sector becomes more and more involved in activities that were traditionally within the sphere of public policing, the greater the likelihood that their negligence could lead to wrongful arrests and even convictions. We see no incoherence in requiring a private investigator to be careful in its investigation; surely

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the client would expect nothing less from the investigator. In our view, to the extent there may be a potential problem of divided loyalties, it is not sufficiently important to negate the *prima facie* duty of care, at least outside the insurance context. This court should not be taken to have decided the question of a private investigation firm's liability in the context of an insurance claim, as the matter is not before us in this case.

***(iv) Analogous circumstances***

67 Finally, in *Elliott* at para. 94, Cromwell J.A. noted that the duty of care contended for in that case was not supported by authority and had not been recognized in "two roughly analogous situations". The two situations were claims by parents against professionals who have been retained by opposite parties or statutory authorities to assess children for child welfare or custody proceedings, and claims against medical assessors retained by insurers and employers to report to them concerning another person's physical or psychiatric condition.

68 However, when he was writing in *Elliott*, Cromwell J.A. did not have the advantage of the Supreme Court of Canada's decision in *Hill*. The circumstances of the private investigation firm are roughly analogous to the police investigators in *Hill* where the Supreme Court of Canada has recognized a duty of care.

***(v) Conclusion with Respect to Aston***

69 In our view, the policy considerations discussed above favour recognizing a duty of care in respect of a private investigation firm retained by an employer to investigate criminal wrongdoing. We emphasize that this conclusion applies only to the liability of private investigation firms in this specific context: when a relationship is created between a private investigator hired by an employer and a specific employee who is being investigated. The question whether there existed such a duty on the facts of the case is a matter that should be determined after a trial.

70 Accordingly, we would allow the appeal and set aside the dismissal in respect of the claim for negligent investigation against Aston.

**(3) Residual Policy Considerations with respect to Canac and Kohler**

71 In the discussion above, we have reviewed the various policy considerations as they apply to the private investigation firm, Aston. One of the strongest considerations favouring recognizing a duty of care for Aston is that it is in the business of investigation, performing functions analogous to those performed by the police. However, different considerations apply when considering the potential liability of an employer such as Canac, even one that embarks upon a criminal investigation of its employee. We rely on two of the considerations referred to by Cromwell J.A. in *Elliott*. The first is the possibility of legal incoherence; the second is the potential chilling effect on non-professional investigators.

72 The fundamental premise of the employer-employee relationship in Canada is the right, subject to contractual terms to the contrary, of either party to terminate the relationship. Thus, in *Wallace*, the Supreme Court of Canada rejected the submission that an employer must have good faith reasons for dismissal or that there could be an independent action or head of damages for breach of such alleged duty of good faith, either in contract or in tort. In our view, it would be inconsistent to nevertheless recognize a duty on an employer not to conduct a negligent investigation regarding an employee. To do so would be to do indirectly what the Supreme Court expressly rejected in *Wallace*.

73 The Supreme Court, for policy reasons explained in *Wallace*, has refused to recognize an action in tort for breach of a good faith and fair dealing obligation. In this case, Canac fired the plaintiff for cause. It concedes that it was wrong in doing so and it may have been negligent. But, in our view, to recognize a tort of negligent investigation for an employer would be inconsistent with the holding in *Wallace*. It would, in effect, carve out an exception from the broad holding in *Wallace* where the reason for the dismissal was an allegation of criminality. We can see no principled reason for so doing.

74 The second reason that we would not recognize a duty of care on Canac lies in the potential chilling effect on reports of criminality by honest citizens to the police. Unlike Aston, Canac was not in the business of investigation. It was in many ways in

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the same position as any other citizen who reports criminal activity to the police. Public policy favours encouraging the reporting of criminality to the police. Someone not in the business of private investigation who honestly, even if mistakenly, provides information of criminal activity should be protected: see *Mirra v. Toronto Dominion Bank*, [2004] O.J. No. 1804 (Ont. S.C.J.).

75 We take a similar view of Kohler and would likewise not recognize a duty of care on Kohler. Kohler was simply assisting its related company. It was more sophisticated than Canac but it was not in the business of investigation as was Aston.

***B. Intentional Infliction of Mental Distress***

*(a) The Reasons of the Motion Judge*

76 Mr. Correia claims intentional infliction of mental distress against each of Canac, its employee Marilyn Smith, Kohler, Aston and its employees Teresa Speciale and Farshid Dhanji. The motion judge addressed this issue only in respect of Canac and Marilyn Smith in her initial reasons, and as against the Aston defendants in clarifying reasons released one week later. The motion judge never specifically dealt with the issue as against Kohler. However, on the appeal, the parties appear to treat the decision of the motion judge on this point as a finding in favour of Kohler as well as Smith.

77 The motion judge refused to grant summary judgment dismissing the claim against Canac. Canac cross-appeals this finding. The motion judge referred to this court's decision in *Prinzo v. Baycrest Centre for Geriatric Care* (2002), 60 O.R. (3d) 474 (Ont. C.A.) at paras. 41-43, for the constituent elements of the cause of action for intentional infliction of mental distress:

(1) flagrant or outrageous conduct on the part of the defendants;

(2) which is calculated to produce harm or in circumstances where it is known that harm will ensue; and

(3) actual damage to the plaintiff as a result of the conduct.

78 Because the facts necessary (a) to prove aggravated and punitive damages in the wrongful dismissal claim, and (b) to prove this tort, would overlap and because the former claims were proceeding to trial against Canac, the motion judge reasoned that no resources would be saved by granting summary judgment with respect to the claim for intentional infliction for mental distress against Canac.

79 The motion judge did, however, grant summary judgment dismissing the claim against Marilyn Smith personally, although she was the employee at Canac who carried out the dismissal. The claim was dismissed against her on the basis that she was acting only in her capacity as human resources manager of Canac, and the principle in *Said v. Butt*, [1920] 3 K.B. 497 (Eng. K.B.), was applicable.

80 In her clarifying reasons, the motion judge held that the claim for intentional infliction of mental distress would be dismissed as against the Aston defendants because their conduct could not be characterized as "outrageous or flagrant".

*(b) Analysis of the Intentional Infliction of Mental Distress Claims*

81 In *Prinzo v. Baycrest*, *supra* at paras. 34-64, this court confirmed a) the three-pronged test to establish the tort of intentional infliction of mental distress and b) that if it is established as an actionable wrong that is separate from wrongful dismissal, then damages for the tort of intentional infliction of mental distress can be awarded in the context of a wrongful dismissal action. Therefore, a claim for intentional infliction of mental distress should not be struck or dismissed only because it is raised in a wrongful dismissal context or because the facts giving rise to the claim may overlap with those that form the basis for aggravated or punitive damages from the wrongful dismissal.

82 In *Prinzo*, this court at paras. 44-46 adopted the formulation of the three-pronged test for the tort of intentional infliction of mental distress as set out by McLachlin J., as she then was, in the British Columbia Supreme Court decision *Rahemtulla v. Vanfed Credit Union* (1984), 51 B.C.L.R. 200 (B.C. S.C.). That case was somewhat similar to this one because it involved the abrupt termination of an employee based on a wrongful charge of theft. There, a bank teller was accused of stealing $2,000

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that another teller could not account for and was summarily dismissed. She suffered mental distress and sued for wrongful dismissal, claiming separately for the damages she suffered for her mental anguish caused by the false allegation of theft and the fallout from that false accusation.

83 McLachlin J. first analyzed the mental distress claim as part of the damages for breach of the contract of employment. She concluded that the damage did not flow from the failure to give adequate notice of dismissal, but from the employee's termination for theft without an opportunity to clear her name, which was not a breach of her contract of employment. Although the employee could not recover these damages as part of her damages from the wrongful dismissal, she could recover in tort. McLachlin J. found, at p. 214, that the bank manager "acted with a reckless disregard as to whether or not shock would ensue from his accusation" and that this was sufficient to make the infliction of mental distress willful. She had no trouble concluding, at p. 215, that the bank's conduct was outrageous: "Allegations of theft should not be made recklessly, without proper care for whether they are true or not."

84 Finally, McLachlin J. concluded, at p. 215, that the bank's conduct was calculated to produce the effect it did because

> [i]t was clearly foreseeable that the accusations of theft which the defendant made against the plaintiff would cause her profound distress. That distress could only be exacerbated by the defendant's failure to conduct a proper investigation or allow the plaintiff to defend herself.

85 In *Prinzo*, at para. 45, this court used similar language noting that this element is made out "if the consequences are known to be substantially certain to follow". It is implicit in the reasons of the motion judge that she was satisfied on the facts before her that Canac's conduct could be found to meet the three-pronged test. It was flagrant and outrageous; it was calculated to cause the distress it did because it was clearly foreseeable that it would; and it caused Mr. Correia significant mental distress. We agree with this conclusion and that there is therefore a triable issue in respect of the intentional infliction of mental distress claim against Canac.

86 It is also implicit in her reasons that the motion judge would have allowed the claim to go ahead against Marilyn Smith, but believed that an action could not be brought against her personally because she was acting in the course of her employment. The motion judge erred in law in this respect. An employee acting in the context or course of employment can be personally responsible in law for his or her tortious conduct: see: *London Drugs Ltd. v. Kuehne & Nagel International Ltd.*, [1992] 3 S.C.R. 299 (S.C.C.); *Alper Development Inc. v. Harrowston Corp.* (1998), 38 O.R. (3d) 785 (Ont. C.A.); *ADGA Systems International Ltd. v. Valcom Ltd.* (1999), 43 O.R. (3d) 101 (Ont. C.A.); *Meditrust Healthcare Inc. v. Shoppers Drug Mart* (1999), 124 O.A.C. 137 (Ont. C.A.).

87 Carthy J.A. explained in *ADGA Systems*, *supra* at 106, that the effect of the rule in *Said v. Butt* is not that it grants immunity for any wrongdoing to employees acting in the course of their employment, but that it grants an exception from personal liability for employees or officers of companies who terminate contracts on behalf of their corporate employers:

> [The rule in *Said v. Butt*] provides an exception to the general rule that persons are responsible for their own conduct. That exception has since gained acceptance because it assures that persons who deal with a limited company and accept the imposition of limited liability will not have available to them both a claim for breach of contract against a company and a claim for tortious conduct against the director with damages assessed on a different basis. The exception also assures that officers and directors, in the process of carrying on business, are capable of directing that a contract of employment be terminated or that a business contract not be performed on the assumed basis that the company's best interest is to pay the damages for failure to perform. By carving out the exception for these policy reasons, the court has emphasized and left intact the general liability of any individual for personal conduct.

88 Marilyn Smith was the person who terminated Mr. Correia and facilitated turning him over to the police to be charged with criminal offences following the negligent investigation, in which she herself made the error that caused blame to be falsely cast on him. In law she may be held personally liable for her conduct. The rule in *Said v. Butt* does not apply here, because we are talking about responsibility for a separate actionable tort, not for the wrongful termination of the contract of employment itself.

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89 A similar analysis must be applied to the Aston defendants as to the Canac defendants. The motion judge did not consider their conduct sufficiently outrageous to meet the first prong of the test for intentional infliction of mental distress. That conduct will now be the subject at trial of an action for negligent investigation. If it is found that Aston was negligent in its investigation, in the context where it knew the serious consequences of a wrongful charge of criminal conduct against an employee, its conduct may well be found to be outrageous and to meet the requirement for intentional infliction of mental distress. When the motion judge's reasons for dismissing the claims for intentional infliction of mental distress against the Aston defendants are viewed in light of this possibility, as well as the motion judge's decision to permit this claim to proceed against Canac, we find that her clarifying reasons do not provide a sufficient basis for granting summary judgment in favour of Aston or its employees on this cause of action.

90 The final defendant is Kohler. It appears that Kohler was not separately considered by the motion judge. There is no basis at this stage to distinguish Kohler's role from Canac's role in the investigation and the actions taken against Mr. Correia for the purpose of considering the claim for intentional infliction of mental distress. For the reasons that the claim can proceed against Canac and Smith, it can also proceed to trial as against Kohler.

***C. Inducing Breach of Contract and Intentional Interference with Economic Relations Against Kohler and Aston***

*(a) The Reasons of the Motion Judge*

91 The motion judge granted summary judgment dismissing the plaintiffs' claims for inducing breach of contract and intentional interference with economic relations against Kohler and Aston. The basis of the claims was that Mr. Correia was terminated by Canac because the actions of Kohler and Aston in conducting and implementing a negligent investigation caused Canac to wrongly terminate him. The motion judge analyzed the elements of each tort and concluded that neither tort could be proved at trial.

*(b) Analysis*

92 These two torts were the subject of significant judicial consideration in 2007, both in this court in the case of *Drouillard v. Cogeco Cable Inc.* (2007), 282 D.L.R. (4th) 644 (Ont. C.A.), and in the House of Lords in its joint disposition of *OBG Ltd. v. Allan*, [2007] UKHL 21 (U.K. H.L.) ["OBG"], which was released the day after *Drouillard*. Both courts sought to reconcile confusing historical case law and to clarify and rationalize the elements of each tort.

93 In *Drouillard*, Cogeco used its influence with a contractor in the Windsor area to ensure that Drouillard, a competent cable installer, was not hired for one position and was fired from another one. At trial, Cogeco was found liable for wrongful interference with economic relations. On appeal, it was held that although Cogeco's actions in speaking to the contractor caused Drouillard to lose his employment, those actions did not amount to "unlawful means", as required for the tort of wrongful interference. However, Cogeco was liable for inducing breach of contract, as its actions satisfied four criteria: (1) Drouillard had a valid and enforceable employment contract; (2) Cogeco was aware of the contract; (3) Cogeco intended to and did procure the breach of that contract because Drouillard was terminated without proper notice; (4) Drouillard suffered damage as a result: see paras. 26-38.

94 In *OBG*, the House of Lords confirmed that despite some historical confusion of the two causes of action, they are distinct in their genesis, purpose, and effect. The action for inducing breach of contract began with the decision in *Lumley v. Gye* (1853), 2 El.& Bl. 216 (Eng. Q.B.), where a theatre owner convinced a noted singer to break her exclusive contract with a rival theatre. Lord Hoffman characterized this tort action as based on the concept that someone "who procures another to commit a wrong incurs liability as an accessory": *OBG* at para. 3. The third party has committed 7an actionable breach of contract. The tortfeasor has acted to procure that breach, and on that basis becomes liable as an accessory to the wrongful conduct.

95 In contrast, the intentional interference action traces its history to cases such as *Garret v. Taylor* (1620), Cro. Jac. 567 (Eng. K.B.) (defendant liable for driving away customers of a quarry by threatening them with mayhem and vexatious lawsuits) and *Tarleton v. McGawley* (1794), 1 Peake 270 (Eng. K.B.) (master of trade ship liable for using cannons to drive away a canoe

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that was approaching a rival trade ship with the intention to sell cargo), in which the defendant's liability was based on the defendant's commission of an *independent* wrong against a third party. In each of these cases, although the actions of the third party in submitting to the defendant's threats provided the immediate cause of the plaintiff's loss, the third party's actions were in no way wrongful. As such, liability for intentional interference is not accessory liability, but rather primary liability "for intentionally causing the plaintiff loss by unlawfully interfering with the liberty of others": *OBG* at para. 6.

96 Over the years, the elements of the torts had come to be confused.[2] Furthermore, the courts had begun to recognize, as part of the inducing breach of contract action, an action for wrongful interference with economic relations that was applicable to situations where a defendant prevented a third party from fully carrying out its contractual obligations with the plaintiff, even though no actual breach of contract occurred, and the impugned conduct was not independently unlawful.

97 In *OBG*, the House of Lords determined to clarify and specifically define the elements of each tort. In doing so, the Lords corrected and, where necessary, overruled formerly precedential cases that, in hindsight, had introduced confusion and error into the definition of the two torts.[3] The result is a clear definition of the two torts and their elements. The Lords were unanimous in all aspects of their definition of the two torts except one — Lord Nicholls disagreed on the scope of the concept of "unlawful means" in the tort of intentionally causing loss by unlawful interference with economic relations.

98 In defining the two torts, the Lords emphasized that both are intentional torts that aim to give redress in the context of deliberate commercial wrongdoing: see *OBG* at paras. 141-143, 145, 191 (Nicholls L.). Where the impugned conduct is merely negligent, then it must be actionable using negligence principles, and if it is not, it cannot be made actionable by recharacterizing it as wrongful commercial interference.

99 The Lords defined the elements of the tort of inducing breach of contract as follows: (1) the defendant had knowledge of the contract between the plaintiff and the third party; (2) the defendant's conduct was intended to cause the third party to breach the contract; (3) the defendant's conduct caused the third party to breach the contract; (4) the plaintiff suffered damage as a result of the breach (see *OBG* at paras. 39-44 (Hoffman L.)). The Lords confined the tort to cases where the defendant actually knew that its conduct would cause the third party to breach (it is not enough that the defendant ought reasonably to have known that its conduct would cause the third party to breach); the defendant must have intended the breach (it is not enough that a breach was merely a foreseeable consequence of the defendant's conduct); and there must be an actual breach (it is not enough for the conduct to merely hinder full performance of the contract).

100 The elements of the tort of causing loss by unlawful means are: (1) wrongful interference by the defendant with the actions of a third party in which the plaintiff has an economic interest; (2) an intention by the defendant to cause loss to the plaintiff: see *OBG* at para. 47 (Hoffman L.). Again, the intentionality of the defendant's conduct is critical: it is not enough that the loss was a foreseeable consequence of the defendant's conduct; to be actionable under this tort, the loss must have been the intended result. Furthermore, intentional conduct that causes loss but is not unlawful, is not actionable. That is considered permissible competitive commercial behaviour.

101 We note that the requirement for intentionality may be stricter for these economic torts than for the tort of intentional infliction of mental distress, where, at least when a person is accused of criminal conduct, the foreseeability of the inevitable consequences of reckless conduct can amount to intent. The difference of approach is justified in this case. The two economic torts are strictly limited in their purpose and effect in the commercial world, where much competitive activity is not only legal but is encouraged as part of competitive behaviour that benefits the economy. In contrast, intentional infliction of mental distress is a personal tort that regulates improper activity that causes mental suffering, which is never socially beneficial. What degree of intent is required may depend on the nature of the conduct that causes the mental distress. As held in *Rahemtulla*, when a person is accused of criminal activity, the potential for mental distress consequences is clearly foreseeable.

102 The question of what amounts to "unlawful means" is the one that has caused the most difficulty for judges and scholars. The majority of the Lords agreed with the following definition found at para. 51 of Lord Hoffman's reasons:

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> Unlawful means therefore consists of acts intended to cause loss to the claimant by interfering with the freedom of a third party in a way which is unlawful as against that third party and which is intended to cause loss to the claimant. It does not in my opinion include acts which may be unlawful against a third party but which do not affect his freedom to deal with the claimant.

103 Lord Hoffman summarized his definition of unlawful means as acts against a third party that are actionable by that third party, or would have been actionable if the third party had suffered a loss. This excludes criminal conduct that is not directed at the third party and is not otherwise actionable by that party. In contrast, Lord Nicholls of Birkenhead views the breadth of conduct under the rubric of "unlawful means" as encompassing any conduct that is deliberately intended to harm the plaintiff and in breach of a legal or equitable obligation under either civil or criminal law. He views the true rationale of the tort as providing a remedy for intentional economic harm "caused by unacceptable means", which includes all means that would violate an obligation under the law: para. 153.

104 Lord Nicholls' approach may be viewed as similar to the one espoused by the decision of this court in *Reach M.D. Inc. v. Pharmaceutical Manufacturers Assn. of Canada* (2003), 65 O.R. (3d) 30 (Ont. C.A.), which adopted Lord Denning's characterization of unlawful means in *Torquay Hotel*, *supra* note 2 at 530, as acts which the tortfeasor "is not at liberty to commit". In *Reach M.D.*, the defendant association made a ruling that was beyond its powers against one of its members, which the court found to constitute "unlawful means". However, Rouleau J.A. in *Drouillard*, *supra* at paras. 19-25, distinguished *Reach M.D. Inc.* and limited its scope, when he concluded that Cogeco's conduct in not following its internal corporate policy or acting in bad faith did not amount to unlawful means and that the tort of intentional interference with economic relations was therefore not made out in that case.

105 With the background of this recent judicial consideration of the two torts, we turn to the application of the relevant principles to this case. Dealing first with the tort of inducing breach of contract, the plaintiffs' claims fail to meet the requirement that the defendants' conduct was intentional in the sense that the defendants intended to procure a breach of contract. Neither Kohler nor Aston intended that Canac breach its contract of employment with the appellant. To the contrary, their intent was not that that his employment would be wrongfully terminated, but that it would be lawfully terminated for cause.

106 A similar analysis applies to the tort of intentional interference with economic relations. Neither Kohler nor Aston intended to cause harm to the appellant by conducting a negligent investigation. Their conduct was not intentional — at most it was negligent. To the extent that they were reckless as to the consequences of their negligent conduct, recklessness does not amount to an intention to cause harm sufficient to make out the tort.

107 We note that it is not necessary to fully define the scope of the "unlawful means" component of the tort of intentional interference with economic relations to resolve this case. The contention of the appellant is that the negligent investigation conducted by Aston and Kohler constituted the unlawful means. As discussed above, although Aston may be held responsible in law for such negligence, Kohler may not. Therefore, on any definition, Aston's conduct could amount to unlawful means if it was intended to cause harm to the appellant. The same conduct by Kohler could not. However, again as discussed above, Aston's alleged negligence is directly actionable by the appellant, based on duty of care and foreseeability principles. There is no need to interpose the tort of intentional interference to obtain redress against Aston. The intentional torts exist to fill a gap where no action could otherwise be brought for intentional conduct that caused harm through the instrumentality of a third party.

108 In the result, for these reasons, we agree with the conclusion reached by the motion judge that the claims based on these two causes of action must be dismissed.

***D. Kohler's Vicarious Liability for the Conduct of its Deceased Employee in Default***

109 The appellants contend that the motion judge's decision erroneously relieved Kohler of vicarious liability for the conduct of Phil Sunstrom, merely because Mr. Sunstrom has passed away. The appellants' argument, however, mischaracterizes the motion judge's decision. The motion judge held only that Canac and Kohler cannot be bound by the deemed admissions of facts

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resulting from the failure of Mr. Sunstrom's estate to enter a defence to the appellants' suit. In so holding, the motion judge did not relieve Kohler of possible vicarious liability for Mr. Sunstrom's conduct.

110 We see no error in the motion judge's decision on this point. The motion judge was correct in reasoning that a deemed admission of facts resulting from a failure to defend is a legal fiction that does not bind other defendants, and that the admissions of a former employee have no authority to bind the employer: see *Bank Leu AG v. Gaming Lottery Corp.* (2001), 29 B.L.R. (3d) 68 (Ont. S.C.J. [Commercial List]) at paras. 88-89, aff'd (2003), 231 D.L.R. (4th) 251 (Ont. C.A.). As such, we would not give effect to this ground of appeal.

**Conclusion**

111 We would allow the appeal to the following extent: the claim for negligent investigation may proceed as against the Aston defendants; the claim for wrongful infliction of mental distress may proceed as against Canac, Marilyn Smith, Kohler and the Aston defendants. The claims over by the York Police respondents in respect of the claims that have been reinstated are also reinstated. We would dismiss the balance of the appeal and the cross-appeal.

**Costs**

112 While success has been divided, the plaintiffs have been largely successful, especially against the Aston defendants, and on important issues. Accordingly, the plaintiffs are entitled to their costs as against the Aston defendants in the amount of $15,000 inclusive of disbursements and G.S.T., and as against the Canac and Kohler defendants in the amount of $5,000 inclusive of disbursements and G.S.T. There will be no costs for or against the York Regional Police defendants.

***D. O'Connor A.C.J.O.*:**

I agree.

*Appeal allowed in part; cross-appeal dismissed.*

Footnotes

* Corrigenda issued by the court on June 25, 2008 and August 21, 2008 have been incorporated herein.

1 The same argument allows a claim for intentional infliction of mental distress in an appropriate case. See *infra* at paras. 76-90.

2 The Lords said this confusion began with *GWK Ltd v. Dunlop Rubber Co. Ltd.* (1926), 42 T.L.R. 376.

3 The Lords held that the following cases were wrongly decided and should not be followed with respect to aspects of their holdings concerning the two economic torts: *Merkur Island Shipping Corp. v. Laughton*, [1983] 2 A.C. 570 (U.K. H.L.); *Millar v. Bassey* (1993), [1994] E.M.L.R. 44 (Eng. C.A.)); *Torquay Hotel Co. v. Cousins* (1968), [1969] 1 All E.R. 522 (Eng. C.A.); *D.C. Thomson & Co. v. Deakin*, [1952] Ch. 646 (Eng. C.A.). The Lords in *OBG* also stated that aspects of the reasoning in the following cases should not be followed: *Dimbleby & Sons v. National Union of Journalists* (1983), [1984] 1 W.L.R. 67 (Eng. C.A.); *GWK Ltd v. Dunlop Rubber Co. Ltd.* (1926), 42 T.L.R. 376 (H.L.); *Quinn v. Leathem*, [1901] A.C. 495 (U.K. H.L.) at p. 510.

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# TAB 15

**SUSAN WINTER WOODLING, as Executrix of the Estate of Albert D. Woodling, deceased, Plaintiff-Appellee, Cross-Appellant v. THE GARRETT CORPORATION, COLT ELECTRONICS COMPANY, PHOENIX AEROSPACE, INC., LOCKHEED CORPORATION and TEXASGULF AVIATION, INC., Defendants; THE GARRETT CORPORATION, COLT ELECTRONICS COMPANY, PHOENIX AEROSPACE, INC., and LOCKHEED CORPORATION, Third Party Plaintiffs-Appellees, THE GARRETT CORPORATION, PHOENIX AEROSPACE, INC., Third Party Plaintiffs-Appellees, Cross-Appellants v. TEXASGULF, INC. and TEXASGULF AVIATION, INC., Third Party Defendants-Appellants, Cross-Appellees**

**Nos. 86-7496, 86-7526, 86-7534, 86-7541**

**UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT**

**813 F.2d 543; 1987 U.S. App. LEXIS 3152**

**November 3, 1986, Argued**
**March 3, 1987, Decided**

**PRIOR HISTORY:** **[**1]** Appeal and cross-appeals from a judgment of the United States District Court for the Southern District of New York after jury trials before Gerard L. Goettel, Judge, awarding plaintiff $1,142,888, including pre-judgment interest, on her claim for the wrongful death of her husband.

**DISPOSITION:** Affirmed as to liability; affirmed in part, vacated and remanded in part as to damages.

**COUNSEL:** Steven R. Pounian, New York, New York (Milton G. Sincoff, Kreindler & Kreindler, New York, New York, on the brief), for Plaintiff-Appellee, Cross-Appellant.

Richard C. Coyle, Seattle, Washington (Sherilyn Peterson, Perkins Coie, Seattle, Washington, on the brief), for Third Party Plaintiff-Appellee, Cross-Appellant The Garrett Corporation.

Randal R. Craft, Jr., New York, New York (John P. Marinan, Haight, Gardner, Poor & Havens, New York, New York, Steven B. Prystowsky, Lester Schwab Katz & Dwyer, New York, New York, Timothy W. Triplett, Blackwell Sanders Matheny Weary & Lombardi, Kansas City, Missouri, on the brief), for Third Party Plaintiff-Appellee, Cross-Appellee Colt Electronics Company, Inc.

Steven G. Emerson, Morris, Larson, King, and Stamper, Kansas City, Missouri (James L. Stengel, Donovan Leisure **[**2]** Newton & Irvine, New York, New York, on the brief), for Third Party Plaintiff-Appellee, Cross-Appellant Phoenix Aerospace Inc.

Philip D. Pakula, New York, New York (Frederick D. Berkon, Mary D. Faucher, Townley & Updike, New York, New York, on the brief) for Defendant-Third Party Defendant-Appellant, Cross-Appellee Texasgulf Aviation, Inc., and Third Party Defendant-Appellant, Cross-Appellee Texasgulf, Inc.

**JUDGES:** Feinberg, Chief Judge, Oakes and Kearse, Circuit Judges.

**OPINION BY:** KEARSE

**OPINION**

**[*545]** KEARSE, Circuit Judge:

Third-party-defendant Texasgulf, Inc. ("TG" or "TGI"), and defendant-third-party-defendant Texasgulf Aviation, Inc. ("TGA"), appeal from a judgment of the United States District Court for the Southern District of New York, entered in these consolidated actions after a series of jury trials before Gerard L. Goettel, *Judge*, in favor of plaintiff Susan Winter Woodling ("Woodling") for $1,142,888, including prejudgment interest, against TG, TGA, and defendants-third-party-plaintiffs The Garrett Corporation ("Garrett"), Phoenix Aerospace, Inc. ("Phoenix"), and Colt Electronics Company ("Colt"), for the wrongful death of her husband Albert D. Woodling ("Albert Woodling"). **[**3]** TG and TGA contend **[*546]** principally that the court erred (1) in failing to direct a verdict in their favor or to grant them judgment notwithstanding the verdict ("n.o.v.") either because they were protected from liability in the present suit by principles of workers' compensation immunity or because Woodling had validly released them from liability, and (2) in failing to grant them a new trial on the ground that there were errors in the evidentiary rulings and instructions to the jury.

Garrett and Phoenix cross-appeal from the judgment against them, contending principally that the court erred (1) in failing to grant them a directed verdict or judgment n.o.v. on the ground that TGA's conduct was a superseding cause that exonerated them from liability, and (2) in calculating the prejudgment interest to be awarded to Woodling. Garrett contends, in the alternative, that if TG and TGA are granted judgment as a matter of law, Garrett is entitled to a new trial because of a variety of alleged trial errors. Woodling cross-appeals from so much of the judgment as limited her recovery to $1,142,888, contending principally that she is entitled to a new trial as to certain elements of damage because **[**4]** of errors in the district court's rulings and instructions.

For the reasons below, we affirm so much of the judgment as holds TG, TGA, Garrett, and Phoenix liable to Woodling; we affirm in part and vacate in part the award of damages and remand for further proceedings.

I. BACKGROUND

On February 11, 1981, a Lockheed Jetstar airplane (the "Jetstar"), owned by TG's wholly-owned subsidiary TGA, crashed near Westchester Airport in Westchester County, New York, killing its two-man crew and all six passengers. Albert Woodling, a 34-year-old Accounting Supervisor employed by TG in Raleigh, North Carolina, was one of the passengers.

In 1982 and 1983, Woodling brought the present actions in the district court under the New York wrongful death statute, N.Y. Est. Powers & Trusts Law ("EPTL") §§ 5-4.1 to 5-4.6 (McKinney 1981 & Supp. 1987); jurisdiction was based on diversity of citizenship. Woodling named as defendants, *inter alios*, TGA as owner and operator of the Jetstar; Phoenix as the designer and manufacturer of generator control units aboard the Jetstar, which were alleged to have malfunctioned and caused the crash; Garrett as the installer of those generator control units; and Colt, **[**5]** which had prepared the installation drawings for those units. Each of the defendants was alleged to have been negligent with respect to events leading to the crash.

TGA, which in 1982 had been dissolved and its assets distributed to TG, denied liability and asserted two affirmative defenses pertinent to its present appeal. First, it contended that TG and TGA were alter egos and that since TG was Albert Woodling's employer, TGA was protected from liability in the present action by North Carolina principles of workers' compensation immunity. Second, TGA contended that Woodling had entered into a valid agreement (the "Release") releasing TG and TGA from liability resulting from the crash in exchange for a payment of $250,000. Woodling, in response to the latter defense, sought rescission of the Release on the ground that TG had procured it by means of material misrepresentations.

The district court tried the action before juries in three stages.

A. *The Trial of the Affirmative Defenses*

The first trial, held in the spring of 1984, dealt with TGA's affirmative defenses. As set forth in greater detail in Part II.A. below, Woodling presented evidence to show that, although TG paid **[**6]** the salaries of all TGA personnel, TGA was governed and operated as an entity separate from TG. The evidence included proof that TGA's pilots and maintenance employees were supervised by TGA officials; that both TG and TGA

repeatedly certified to various state and federal agencies that TGA both owned and operated the aircraft; and that TGA entered into contracts in its own name for the lease, modification, and storage of aircraft and for the training and temporary employment of pilots. There was documentary **[*547]** and testimonial evidence that the technical aviation decisions with respect to TGA operations were made by TGA alone, not by TG.

As discussed in Part II.B. below, Woodling testified that she had signed the Release in reliance on TG officials' representations, *inter alia*, that TGA was essentially a shell that had "no employees," no "power to hire and fire the pilots and ground personnel," and "no business operations beyond holding title to the former TGI aircraft." Woodling testified that she had understood these representations to mean that TGA would have a workers' compensation defense to any wrongful death action she might bring. She also testified that she signed the Release because she was informed by TG and its insurer, **[**7]** United States Aircraft Insurance Group ("USAIG"), that a $250,000 insurance benefit payable to Albert Woodling's estate could not be received unless she signed such a release. Woodling testified that she was unaware that TG had another insurance policy with American Home Assurance Company ("American Home") which did not require such a release and which on its face covered aircraft accidents if the aircraft was not "owned or operated by the Policyholder," defined therein as "Texasgulf, Inc." She stated that had the existence and terms of the American Home policy been revealed to her, she would not have signed the Release.

TGA introduced the Release, which stated in part as follows:

> This Release reflects the entire agreement between Releasor and Releasee concerning the subject matter hereof. Releasor has carefully read and fully understands the provisions of this Release and knows the contents thereof, and signs the same as Releasor's own free act, and avers that Releasor has not been influenced to any extent whatsoever in making and signing same by any representations or inducements whatsoever by Releasee, other than as set forth herein.

In addition, TGA introduced proof that the **[**8]** American Home policy did not in fact cover the death of Albert Woodling because the language that appeared to cover that event was the inadvertent result of a mutual mistake between TG and the carrier. TGA moved for a directed verdict in its favor on the basis of either or both of its affirmative defenses.

The district court denied the motion and submitted special interrogatories to the jury with respect to each defense. The court instructed the jury that in fact Albert Woodling's death was not covered by the American Home policy and that the jury should decide whether the nondisclosure of the policy with its mistaken facial coverage was a fraudulent or material misrepresentation.

The jury found in favor of Woodling on both of TGA's defenses. Rejecting the workers' compensation immunity defense, the jury found that TG and TGA were separate entities and that TGA was the employer of the flight crew and maintenance personnel involved in the events leading to the crash. Rejecting the release defense, the jury found that TGA was the operator of the airplane involved in the crash, that TG or USAIG had made fraudulent or material misrepresentations both with regard to the status and operations **[**9]** of TGA and with regard to the existence and coverage of the American Home policy, and that Woodling had justifiably relied on each set of misrepresentations in signing the Release. *See Gregory v. Garrett Corp.*, 589 F. Supp. 296, 298-99 (S.D.N.Y. 1984).

TGA moved unsuccessfully for judgment n.o.v. and for a new trial. In addition, on the ground that Woodling should not be allowed to rescind the Release agreement without returning the consideration she received, TG and TGA moved for an order requiring Woodling to return to TG its $250,000. The court granted this motion, and in order not to compromise TGA's ability to pursue on appeal its challenge to the decision allowing rescission of the Release, the court allowed Woodling to place the money in an interest-bearing escrow account. The court denied the request that Woodling be required to pay TG interest on the $250,000 for the period during which **[*548]** she had retained possession of it. *See id.* at 301 n.10.

B. *The Trial of the Liability Issues*

In the fall of 1984, the liability issues were tried. The jury found that the four defendants who are parties to this

appeal were, to varying degrees, negligent and jointly liable for **[**10]** causing the crash. The jury assessed the relative culpability of these defendants as follows: TGA, as owner and operator of the Jetstar, 70%; Garrett, installer of the generator control units on the Jetstar, 20%; Phoenix, designer and manufacturer of the units, 5%; and Colt, preparer of the installation drawings, 5%.

No defendant challenges here the sufficiency of the evidence to support the finding of its negligence. The principal appellate issues arising from the liability trial are the contentions of Garrett and Phoenix that they were entitled to a directed verdict or to judgment n.o.v. on the ground that the conduct of TGA was a supervening cause of the crash that entirely exonerated them from liability. These contentions and the pertinent evidence at the liability trial are discussed in Part II.C. below.

C. *The Trial of the Damages Issues*

In March 1986, the damages issues were tried. Woodling sought damages for past and future losses of support, services, and fatherly care and guidance. She presented, *inter alia*, evidence that Albert Woodling's annual salary at the time of his death was approximately $32,000 and expert testimony as to his reasonably expected increases **[**11]** from age 34 to retirement and the likely effect of inflation on those earnings. The trial court permitted defendants to cross-examine Woodling's expert as to the likely effect of income taxes and social security taxes on Albert Woodling's lost future earnings.

The court submitted interrogatories to the jury with respect to each element of damage claimed by Woodling. It instructed the jury to deduct likely income taxes from Albert Woodling's gross income in calculating the amount to be awarded for lost support; no instruction was given with regard to the effect of social security taxes. As to the proper discount rate, reduced for the effect of inflation, the court instructed the jury as follows:

> The plaintiffs' expert has suggested that the real investment return rate is 1 percent per year after allowing for the effects of inflation. Our appellate court has suggested that from an analysis of long term figures the real investment return rate has averaged one and a half or 2 percent per year. But these figures vary from time to time depending on economic conditions. You must determine what figure is appropriate in bringing the award down to present value.
>
> Thus, you must award one sum **[**12]** for each of the future pecuniary losses which when invested will provide the widow and children with the same increasing values of future support[,] care and services that Albert Woodling if still alive would have provided to his family.

The jury returned its special verdict awarding Woodling a total of $1,055,000 for the following categories of injury:

| | |
|---|---|
| Past loss of support | $150,000 |
| Future loss of support | $600,000 |
| Past loss of fatherly care and guidance | $ 25,000 |
| Future loss of fatherly care and guidance | $235,000 |
| Past loss of services | $ 20,000 |
| Future loss of services | $ 25,000 |

Following this verdict, the court entered the final judgment here appealed, awarding Woodling the $1,055,000, plus $87,888 representing prejudgment

interest for the period between Albert Woodling's death and the entry of judgment on the sums awarded for past losses, for a total of $1,142,888. The judgment reflected the jury's assessment of defendants' relative culpability (TGA 70%; Garrett 20%; Phoenix and Colt 5% **[**13]** each) by providing that each defendant was entitled to contribution from the others in accordance with that assessment.

Although TG had not been sued directly by Woodling, the court entered the judgment in Woodling's favor against TG as well on the basis that when TGA, as TG's wholly owned subsidiary, was dissolved in **[*549]** 1982, assets in excess of the amount of the judgment were distributed to TG. Motions to vacate or modify the judgment were denied, and these appeals followed.

D. *The Issues on These Appeals*

On appeal, the parties renew various of the contentions they made during and after the trials below. Defendants other than Colt contend principally that they were entitled to judgment as a matter of law finding them not liable to Woodling and that, even if they were liable, the court erred in calculating the prejudgment interest to which Woodling was entitled. Woodling contends that the court erred in instructing the jury as to damages and in calculating prejudgment interest.

For the reasons below, we find no merit in defendants' contentions on the liability issues. As to the damages issues, we conclude that the court erred in (1) allowing the jury to deduct income taxes from **[**14]** Albert Woodling's future lost earnings, (2) calculating the prejudgment interest to which Woodling was entitled, and (3) failing to require Woodling to pay TG interest on the $250,000 for the period during which she had use of that money prior to her rescission of the Release agreement.

II. LIABILITY

In challenging so much of the judgment as held them liable to Woodling, TG and TGA contend principally that TGA was entitled to judgment as a matter of law on its defenses of workers' compensation immunity and release. Garrett and Phoenix contend principally that they were entitled to judgment as a matter of law on the ground that, because of TGA's supervening conduct, their own negligence was not a proximate cause of the crash. We find no merit in any of defendants' liability arguments.

A. *TGA's Workers' Compensation Immunity Defense*

Under North Carolina law, which the parties agree governs TGA's Workers; compensation immunity defense, if an employer is covered by the Workers' Compensation Law, suit may not be brought by or on behalf of an employee injured or killed in the course of his employment on the basis of negligence of the employer or a fellow employee. *See* N.C. Gen. Stat. **[**15]** §§ 97-2, 97-9, 97-10.1 (1985). TGA contends principally that Woodling's suit was barred under this statute either because TGA was the alter ego of TG and hence should be treated as Albert Woodling's employer for these purposes, or because, in light of TG's payment of the salaries of TGA personnel, both these personnel and TGA were employees of TG and hence fellow employees of Albert Woodling. We conclude that the district court did not err in refusing to uphold either of these contentions as a matter of law, for both depended on factual premises as to which, on the basis of the evidence presented at trial, reasonable minds could reject TGA's view.

Whether one is an employee of a particular employer within the meaning of N.C. Gen. Stat. § 97-2(2) is a question of fact to be determined by applying the common-law tests for finding an employer-employee relationship. *See Hayes v. Board of Trustees of Elon College*, 224 N.C. 11, 29 S.E.2d 137, 140 (1944); *Carter v. Frank Shelton, Inc.*, 62 N.C. App. 378, 303 S.E.2d 184, 187 (1983), *review denied*, 310 N.C. 476, 312 S.E.2d 883 (1984). The right to control the employee, *i.e.*, "the power to set work hours, assign duties and establish **[**16]** the manner of performance," is determinative of who is the employer. *Barrington v. Employment Security Commission*, 55 N.C. App. 638, 286 S.E.2d 576, 579, *review denied*, 305 N.C. 584, 292 S.E.2d 569 (1982); *accord Lucas v. Li'l General Stores*, 289 N.C. 212, 221 S.E.2d 257, 261-62 (1976); *Carter v. Frank Shelton, Inc.*, 303 S.E.2d at 187. In the absence of supervisory control, the payment of salary and the right to hire and discharge are insufficient to establish employer status. *See Barrington v. Employment Security Commission*, 286 S.E.2d at 579; *Godley v. County of Pitt*, 54 N.C. App. 324, 283 S.E.2d 430, 432 (1981), *rev'd on other grounds*, 306 N.C. 357, 293 S.E.2d 167 (1982); *Forgay v. North Carolina State University*, 1 N.C. App. 320, 161 S.E.2d 602, 606 (1968). Whether such **[*550]** control exists is usually a question of fact for the jury. *See* Restatement (Second) of Agency § 220 comment *c* (1958).

There could be little question that the Jetstar was operated by TGA. There was evidence that TG and TGA had repeatedly certified to various state and federal agencies that TGA owned and operated the aircraft; indeed, they twice made such certifications with **[**17]** specific reference to the crash at issue here. Under the above principles, therefore, the principal fact question for the jury was which company had supervisory control of the TGA personnel at the pertinent times. Taking the evidence in the light most favorable to Woodling as nonmoving party and giving her the benefit of all reasonable inferences and credibility evaluations, as we must in reviewing a denial of a motion for judgment n.o.v., *see, e.g., Mattivi v. South African Marine Corp.*, 618 F.2d 163, 167-68 (2d Cir. 1980), we conclude that there was ample proof that TGA, not TG, had supervisory control of TGA personnel with respect to all matters of flight safety and operation.

First, there was evidence that TGA personnel could not be overruled by TG personnel on matters of flight safety and operation. The TGA Operations Manual stated that the captain of the airplane has

> complete and final authority as to its operation . . . At any time, the Captain may delay, re-route or terminate a trip for any reason which, in his opinion, may compromise the safety of the passengers and the aircraft. UNDER NO CIRCUMSTANCES WILL ANY PASSENGER BE ALLOWED TO OVERRULE THE CAPTAIN CONCERNING **[**18]** THE CONDUCT OF THE FLIGHT.

(Emphasis in original). A number of witnesses testified that the TGA pilots, not TG personnel, in fact made the determinations concerning when and which planes could fly, when to cancel flights for mechanical or other safety reasons, and when to divert aircraft in mid-flight for safety reasons. These witnesses included TGA's chief pilot and the widow of TG's Chairman who died in the crash. In addition there was evidence that TGA's president and its director of maintenance personally supervised the operations of the TGA pilots and maintenance personnel.

Plainly there was sufficient evidence to permit the jury to infer that at the time of the crash the Jetstar was operated by TGA personnel under the supervision and control of TGA and that TG did not control those operations. Accordingly, there was no basis for the requested ruling that TG was as a matter of law the employer of either TGA or TGA's personnel.

TG and TGA also argue that N.C. Gen. Stat. § 97-9's extension of the employer's immunity to "those conducting his business" entitled TGA to judgment. We disagree, for it was not established as a matter of law either that TG and TGA were alter egos or **[**19]** that TGA was merely conducting the business of TG. The evidence was that TG, which was substantially foreign-owned, had set up TGA as a separate entity incorporated in the United States for the purpose of registering aircraft with the Federal Aviation Agency. TG chose the name "Texasgulf Aviation, Inc." because, according to TG board of directors minutes, it was "not so similar to the name of [TG] as to tend to confuse or deceive." TGA had a board of five directors; only one was also a director of TG. TGA operated out of White Plains, New York, while TG made and signed contracts in its own name, including contracts for the lease, modification, and storage of its aircraft and contracts for the training of pilots. TGA personnel referred to themselves as employees of TGA, not of TG. And, as discussed above, TGA, not TG, had the final say with respect to all important matters of the flight and safety of TGA aircraft.

These facts, which would have sufficed to insulate TG from common-law liability for the acts of TGA, also sufficed to defeat this facet of TGA's workers' compensation immunity defense, for a North Carolina court would not find TGA to have been conducting the business of TG **[**20]** within the meaning of § 97-9 if it could not hold TG liable for TGA's acts. *See Lewis v. Barnhill*, **[*551]** 267 N.C. 457, 148 S.E.2d 536, 544 (1966); *see also McWilliams v. Parham*, 269 N.C. 162, 152 S.E.2d 117, 122 (1967) (stockholder does not possess corporation's workers' compensation immunity from suit); *cf. Thomas v. Maigo Corp.*, 37 A.D.2d 754, 754, 323 N.Y.S.2d 106, 106-07 (4th Dep't 1971) (subsidiary that was distinct legal entity was not employee of parent for purposes of workers' compensation immunity); *Daisernia v. Co-operative G.L.F. Holding Corp.*, 26 A.D.2d 594, 594-95, 270 N.Y.S.2d 542, 543 (3d Dep't 1966) (same).

The vast majority of courts have declined to

disregard the corporate veil to extend one corporation's workers' compensation immunity to another. *See O'Brien v. Grumman Corp.*, 475 F. Supp. 284, 292 (S.D.N.Y. 1979) (collecting cases); Annot., 30 A.L.R. 4th 948, 951 (1983) (same). The North Carolina case most closely on point refused to do so even when the parent and subsidiary shared administrative offices, purchasing agents, personnel department, and sales organization. *See Phillips v. Stowe Mills, Inc.*, 5 N.C. App. 150, 167 S.E.2d 817, 820 (1969); **[**21]** *cf. Thomas v. Maigo Corp.*, 37 A.D.2d at 754, 323 N.Y.S.2d at 106 (subsidiary was separate legal entity from parent and was not covered by parent's immunity even though subsidiary was wholly-owned, controlled, dominated, and financed by parent). Given the significant legal and corresponding financial advantages of separate incorporation, we decline to extend North Carolina law so as to disregard the corporate veil in order to expand workers' compensation immunity and thereby remove one of the few reciprocal burdens of such advantages. *See Boggs v. Blue Diamond Coal Co.*, 590 F.2d 655, 662 (6th Cir.), *cert. denied*, 444 U.S. 836, 100 S. Ct. 71, 62 L. Ed. 2d 47 (1979).

B. *TGA's Release Defense*

Woodling sought rescission of the Release she had signed in favor of TG and TGA on the ground that she had been induced to sign it as a result of material misrepresentations with respect to two matters: TG's total control over TGA's operations and the availability of an insurance benefit to Albert Woodling's estate under the American Home policy. The jury answered interrogatory questions favorably to Woodling on both issues, and rescission was granted. TG and TGA ask us to uphold the validity of the Release on **[**22]** a variety of grounds or at least to grant a new trial because of alleged errors in the conduct of the trial. We find their arguments with respect to the misrepresentations as to TGA operations to be without merit, and since this ground for rescission was independent of the question of whether Woodling had also relied on misrepresentations as to available insurance benefits, we need not reach the latter ground.

1. *Choice of Law*

The Release provided that "the validity, effect and enforceability, as well as the rights of the parties hereto regarding this Release shall be governed, construed and interpreted solely in accordance with the laws of the State of Connecticut." Since this is a diversity action, the district court, sitting in New York, properly looked to the choice-of-law rules of New York to determine whether and to what extent the parties' contractual choice should be honored.

When such a provision exists and the jurisdiction chosen by the parties has a substantial relationship to the parties or their performance, New York law requires the court to honor the parties' choice insofar as matters of substance are concerned, so long as fundamental policies of New York law are **[**23]** not thereby violated. *See A.S. Rampell, Inc. v. Hyster Co.*, 3 N.Y.2d 369, 381, 165 N.Y.S.2d 475, 486, 144 N.E.2d 371 (1957); Restatement (Second) of Conflict of Laws § 187 (1971). The contractual choice of law provision is deemed to import only substantive law, however, not procedural law. *See Sears, Roebuck & Co. v. Enco Associates, Inc.*, 43 N.Y.2d 389, 397, 401 N.Y.S.2d 767, 772, 372 N.E.2d 555 (1977); *Gambar Enterprises, Inc. v. Kelly Services, Inc.*, 69 A.D.2d 297, 304, 418 N.Y.S.2d 818, 822 (4th Dep't 1979); Restatement (Second) Conflict of Laws § 187(3) & comment *h*.

**[*552]** The issues of the validity and enforceability or voidability of a release are plainly matters of substance as to which the parties' choice of law will be honored. *See Siegelman v. Cunard White Star Ltd.*, 221 F.2d 189, 194-95 (2d Cir. 1955); Restatement (Second) of Conflict of Laws § 201 & comment *a*. The extent to which the parol evidence rule may be applicable to bar extraneous evidence to show the voidability of a release is also considered by New York conflicts law to be a matter of substance. *See Smith v. Bear*, 237 F.2d 79, 83 (2d Cir. 1956); Restatement (Second) of Conflict of Laws § 205 comment *e*. The question **[**24]** of burden of proof, on the other hand, is regarded by New York law as a question of procedure to which the law of the forum applies. *See Lobel v. American Airlines, Inc.*, 192 F.2d 217, 219 (2d Cir. 1951), *cert. denied*, 342 U.S. 945, 72 S. Ct. 558, 96 L. Ed. 703 (1952); *Clark v. Harnischfeger Sales Corp.*, 238 A.D. 493, 495, 264 N.Y.S. 873 (2d Dep't 1933); *Wright v. Palmison*, 237 A.D. 22, 22, 260 N.Y.S. 812, 813 (2d Dep't 1932).

Since Connecticut is the principal place of business of TG, the court properly honored the parties' contractual choice of Connecticut law with regard to matters of substance, and looked to that law with respect to the issues of the validity and enforceability or voidability of the Release, and with respect to the admissibility of parol

evidence on those issues. It properly applied the law of New York on the issue of burden of proof.

2. *Representations Concerning TGA's Operations*

Woodling testified that prior to signing the Release, she had received a letter from TG purporting to set forth "information [that] pertains to the relationship between [TG] and [TGA]." The letter stated that TGA had "no employees" and "no business operations beyond holding title to the former **[**25]** TGI aircraft"; that "all pilots and aircraft support personnel are employees of TGI at Stamford, Connecticut"; and that "TGI has the sole power to hire and fire the pilots and ground personnel." TG and TGA contend that they were entitled to have judgment as a matter of law dismissing this basis for rescission because, *inter alia*, the claimed misrepresentations were matters of opinion rather than fact, they were fair and reasonable, and, in any event, Woodling could not justifiably rely on them. We find no merit in any of these contentions.

Under Connecticut law, even an innocent material misrepresentation can provide grounds for avoidance of a contract. *See Duksa v. City of Middletown*, 173 Conn. 124, 376 A.2d 1099, 1101 (1977). To be a misrepresentation, however, a statement must falsely assert fact rather than opinion. *See* Restatement (Second) of Contracts § 159 & comment *a* (1981). The test for whether a statement is one of opinion or fact is whether "under the circumstances surrounding the statement, the representation was intended and understood as one of fact as distinguished from one of opinion." *Crowther v. Guidone*, 183 Conn. 464, 441 A.2d 11, 13 **[**26]** (1981); *see also Board of Water Commissioners of City of New London v. Robbins & Potter*, 82 Conn. 623, 74 A. 938, 943 (1910) (estimates supplied as approximately correct "information" to be relied on were statements of fact not opinion). Moreover, a statement of opinion, including one regarding the application of the law to facts, impliedly asserts that the facts known to the maker are not incompatible with that opinion. *See* Restatement (Second) of Contracts §§ 168(2)(a), 170 comment *b*. Of course, even if the facts explicitly and implicitly represented are literally true, there may still be a misrepresentation if the statement is a half-truth because it omits reference to material unfavorable matter. *See id.* § 159 comment *b; Duksa v. City of Middletown*, 376 A.2d at 1101; *Franchey v. Hannes*, 152 Conn. 372, 379, 207 A.2d 268, 271 (1965); *Wedig v. Brinster*, 1 Conn. App. 123, 469 A.2d 783, 788 (1983), *cert. denied*, 192 Conn. 803, 472 A.2d 1284 (1984).

The evidence at trial was sufficient to show that the TG representations as to its control over TGA operations were intended as and taken as assertions of fact. The **[*553]** letter itself characterized these assertions **[**27]** as "information." TG's Senior Counsel, Eugene McGuire, testified that these assertions were not the product of any legal research; he referred to them as "facts." Woodling testified that at a meeting with a TG representative these matters were discussed as "facts" that would provide a basis for a workers' compensation defense if Woodling were to bring suit against TGA. The trial court properly instructed the jury that TGA had the burden of proving that the Release was valid, *see Mangini v. McClurg*, 24 N.Y.2d 556, 563, 301 N.Y.S.2d 508, 514, 249 N.E.2d 386 (1969), and that if the jury found the assertions merely to be opinions it should find in favor of TGA. The jury's finding that these were assertions of purported fact was a fair inference from the trial evidence and may not be set aside.

The question of whether these representations were fair and reasonable conclusions on the part of TG also presented a fact issue that, in light of the evidence at trial, was an entirely inappropriate basis for a directed verdict or judgment n.o.v. There was ample evidence as to TGA's unfettered control over its own aviation activities, discussed in Part II.A. above, from which the jury could have concluded **[**28]** that the representations were literally false or at best half-truths.

Notwithstanding a defendant's express or implied misrepresentations, a plaintiff may be denied recovery under Connecticut law if reliance on those misrepresentations was unjustified. When the premise of such unjustifiability is the plaintiff's failure to discover the truth, Connecticut law precludes recovery only if that failure was so extreme as to be, in itself, a breach of good faith and fair dealing. *Pacelli Brothers Transportation, Inc. v. Pacelli*, 189 Conn. 401, 456 A.2d 325, 329 (1983); Restatement (Second) of Contracts § 172 & comment *a*. Consequently, the plaintiff's failure to make a reasonable investigation does not bar relief unless the truth would have been uncovered by even a cursory examination. *Id.* § 172 comment *b; see Clark v. Haggard*, 141 Conn. 668, 109 A.2d 358, 361 (1954); *Kavarco v. T.J.E., Inc.*, 2 Conn. App. 294, 478 A.2d 257, 262 (1984). A plaintiff's mere negligence in failing to discover that a

representation was false is no defense to an action for rescission. *Id.* Nor do general principles of common law bar an action based on reliance on representations made by **[**29]** a lawyer for an antagonistic interest, even when the recipient is also represented by a lawyer. *See, e.g., Sainsbury v. Pennsylvania Greyhound Lines*, 183 F.2d 548, 550-52 (4th Cir. 1950); *National Conversion Corp. v. Cedar Building Corp.*, 23 N.Y.2d 621, 626, 298 N.Y.S.2d 499, 503, 246 N.E.2d 351 (1969); *Madison Trust Co. v. Helleckson*, 216 Wis. 443, 257 N.W. 691, 693-95 (1934); *cf.* Restatement (Second) of Torts §§ 540 & comment *a*, 541 comment *a* (1977) (independent investigation not required to make reliance justifiable even when maker of misrepresentation is an adverse party). If anything, a lawyer's duties of professional responsibility render such reliance on factual representations particularly justifiable. *See generally Sainsbury v. Pennsylvania Greyhound Lines*, 183 F.2d at 551-52; *cf.* A.B.A. Model Code of Professional Responsibility DR 7-102(A)(5) (1983) ("a lawyer shall not . . . knowingly make a false statement of law or fact").

Woodling's reliance on the statements of McGuire, a member of the bar, in the context of a relationship that both she and McGuire characterized as one of trust and confidence regarding facts concerning TG's and TGA's internal operations **[**30]** cannot be characterized, as a matter of law, as a breach of good faith and fair dealing on her part. Plainly it would have taken far more than a cursory examination by her to reveal the actual facts.

Reliance by TG and TGA on *Krupa v. Kelley*, 5 Conn. Cir. Ct. 127, 245 A.2d 886 (1968), is misplaced. In *Krupa*, an insurance company offered plaintiffs $3,000, stating that was what their claim was worth. The plaintiffs declined the offer. When they later sought to avoid the bar of the statute of limitations, the court held there had been no fraudulent concealment. 245 A.2d at 890. In *Krupa*, unlike the present case, there was no proof that the **[*554]** defendant misrepresented or even knew of adverse facts and the plaintiffs' rejection of the settlement offer conclusively proved there was no reliance at all.

Finally, Woodling's claim of reliance on the statements as to TG's control of TGA's operations was not barred by the disclaimer in the Release stating that she "ha[d] not been influenced to any extent whatsoever in making and signing same by any representations or inducements whatsoever by [TG and TGA]." It is well settled under Connecticut law that parol evidence is admissible to show **[**31]** fraud or misrepresentation. *See Jay Realty, Inc. v. Ahearn Development Corp.*, 189 Conn. 52, 453 A.2d 771, 773 (1983); *Paiva v. Vanech Heights Construction Co.*, 159 Conn. 512, 271 A.2d 69, 73-74 (1970); *Kiss v. Kahm*, 132 Conn. 593, 46 A.2d 337, 338 (1946). The presence of a disclaimer such as that signed by Woodling provides no exception to this general rule. *See New Haven Tile & Floor Covering Co. v. Roman*, 137 Conn. 462, 78 A.2d 336, 337 (1951) (even though written agreement stated that terms could not "be varied by any verbal representation or promise," parol evidence to show that agreement was not binding and valid was admissible); *see also* Restatement (Second) of Contracts § 214 comment *e; cf. Sabo v. Delman*, 3 N.Y.2d 155, 160-62, 164 N.Y.S.2d 714, 717-19, 143 N.E.2d 906 (1957) (general merger clauses do not bar claim for misrepresentation).

In sum, the trial court properly applied the pertinent principles of governing law. TGA was not entitled to a directed verdict or judgment n.o.v. on its defense of release, and we see no basis for overturning the jury's findings against it.

C. *The Supervening Cause Arguments of Garrett and Phoenix*

The principal contentions **[**32]** of Garrett and Phoenix on their appeals are that they were entitled to judgment n.o.v. because their negligence, conceded for purposes of these arguments, was not the proximate cause of the crash of the Jetstar because of the supervening conduct of TGA. We reject these contentions.

Preliminarily, we note our rejection of Woodling's contention that these arguments were not properly preserved for appeal. Phoenix's written motion for a directed verdict specifically referred to lack of proximate cause as a ground. The oral motions of both Phoenix and Garrett for a directed verdict were made "on all possible grounds," and the district court stated this was "sufficient" to preserve the record. Woodling neither objected to the lack of specificity in the directed verdict motions nor opposed the judgment n.o.v. motions on this ground. On this record, the issue of the sufficiency of the evidence concerning proximate cause was preserved for appeal. *See, e.g., Mosley v. Cia. Mar. Adra, S.A.*, 362 F.2d 118, 121-22 (2d Cir.), *cert. denied*, 385 U.S. 933, 87 S. Ct. 292, 17 L. Ed. 2d 213 (1966).

The evidence at the liability trial painted the following picture as to the cause of the crash. At 6:40 p.m. on February 11, 1981, **[**33]** in darkness, with visibility limited by weather, the Jetstar was attempting an instrument landing approach. The jet's electrical equipment, including the cockpit navigation instruments, was powered by four engine generators, each regulated by its own generator control unit ("GCU"). As the plane descended, the GCUs "tripped" the four generators, *i.e.*, disconnected them from the electrical equipment. At first, backup batteries provided power for resetting the generators and essential equipment; but the GCUs continued to disconnect intermittently, depleting and finally exhausting the batteries. The final tripping occurred when the plane was about 500 feet above the ground. The plane crashed some 20 seconds later, a mile short of the runway and 2,300 feet to the right of course.

The generators had been installed in the Jetstar by Garrett in late January 1981. On January 31, Garrett's electrician was present during TGA's ensuing test flights. On the first of those flights a single generator tripped, was reset, tripped again, and was reset again; then all four generators **[*555]** tripped. On a second test flight, one generator again tripped twice and had to be reset. On a third flight, there **[**34]** was no tripping. Garrett employees testified that they never discovered the cause of the problem, but they told TGA that the tripping problem had been solved.

There was testimony that TGA reported further tripping problems to Garrett on two other occasions prior to the date of the crash. Garrett's electrical shop supervisor testified that from these reports he "knew the condition still existed." Garrett personnel admitted that they knew Garrett did, at its own facility, all major maintenance for TGA aircraft and that TGA relied on Garrett's expertise, including that concerning electrical problems. Garrett never advised TGA to ground the Jetstar because of the tripping.

The generators had been designed by Phoenix. In the ten days prior to the crash, Phoenix was informed once of a double tripping of the generators and once that three generators had tripped. On the day of the crash, a TGA official informed Phoenix that multiple tripping had occurred that morning. Phoenix admitted that it knew TGA was relying on its knowledge and advice with respect to the proper functioning and safety of the generators. It never advised TGA to ground the plane.

Woodling's expert witnesses testified that **[**35]** the multiple tripping should have indicated that a systemic problem remained, that both Phoenix and Garrett had greater expertise than TGA with respect to such problems, that Garrett should have asked TGA to ground the Jetstar until Garrett could repair it, and that Garrett should have known that TGA would be unable on its own to know whether the problem was solved.

In support of their arguments that TGA's conduct was the supervening cause of the crash and hence relieves them of liability as a matter of law, Garrett and Phoenix point principally to evidence that TGA's pilots and maintenance director were aware of all of the incidents of tripping; that they were aware that at least three of the four generators had tripped out during a flight on the morning of the crash and had been off-line for several minutes; and that TGA pilots were aware of the weather forecast for the Westchester area on the evening of the crash, which predicted an overcast sky, fog, occasionally heavy rain, light thunder showers, winds at 15 knots, and obscured visibility. TGA's chief pilot testified that in order to fly in such conditions, a plane is required to have flight instruments that are working and that **[**36]** the loss of all four generators would be unacceptable at night or in bad weather conditions because that loss would soon exhaust the backup battery power and leave the pilot without means to navigate the plane.

Given all the evidence, the proximate cause issues were properly submitted to the jury. Under New York law, which the parties agree governs the tort issues in this case, notwithstanding the intervention of an act of a third person between the original negligence and the ultimate injury, the original negligent actor can be found to have proximately caused the injury if the intervening act was normal or foreseeable. *See Derdiarian v. Felix Contracting Corp.*, 51 N.Y.2d 308, 315-16, 434 N.Y.S.2d 166, 169-70, 414 N.E.2d 666 (1980) ("*Derdiarian*"); *Bonsignore v. City of New York*, 683 F.2d 635, 638 (2d Cir. 1982); *Vasina v. Grumman Corp.*, 644 F.2d 112, 114-15 (2d Cir. 1981) ("*Vasina*"). When, as is usually the case, circumstances permit varying inferences as to the foreseeability of the intervening act, the proximate cause issue is a question of fact for the jury. *See Derdiarian*, 51 N.Y.2d at 315, 434 N.Y.S.2d at 170; *Vasina*, 644 F.2d at 114. If the intervening act **[**37]** was foreseeable, it does not excuse the original actor that the intervening act was "reckless," *Derdiarian*, 51 N.Y.2d at 316, 434 N.Y.S.2d at 170, or intentional, *see Kush v. City of*

*Buffalo*, 59 N.Y.2d 26, 33, 462 N.Y.S.2d 831, 835, 449 N.E.2d 725 (1983), or even intentional and criminal, *see Nallan v. Helmsley-Spear, Inc.*, 50 N.Y.2d 507, 520-21, 429 N.Y.S.2d 606, 614, 407 N.E.2d 451 (1980); *Bonsignore v. City of New York*, **[*556]** 683 F.2d at 638. *A fortiori*, the fact that the intervening actor, such as an employer who controls defective machinery, knows of the dangers and merely fails to warn or otherwise protect the plaintiff does not of itself relieve the original actor from liability. *See Cohen v. St. Regis Paper Co.*, 65 N.Y.2d 752, 754, 492 N.Y.S.2d 22, 24, 481 N.E.2d 562 (1985); *accord Farley v. Edward E. Tower & Co.*, 271 Mass. 230, 171 N.E. 639, 642-43 (1930). Nor should we strain to relieve a negligent party from responsibility because of an intervening act when the original negligence created a situation of "extreme danger." *Prosser & Keeton on the Law of Torts* § 44, at 319 (5th ed. 1984); *cf. Gordon v. Niagara Machine & Tool Works*, 574 F.2d 1182, 1193-94 (5th Cir. 1978) (high likelihood and grievous **[**38]** nature of potential harm are factors in finding that employer's failure to pass on warnings was not a supervening cause).

The trial evidence, taken in the light most favorable to Woodling, provided an ample basis for submitting the proximate cause issues to the jury. To Garrett's and Phoenix's knowledge, TGA had been flying the Jetstar despite ongoing tripping problems for more than a week. It was thus entirely reasonable for the jury to conclude that it was foreseeable to both Garrett and Phoenix that despite the systemic problems with the generators, TGA would not on its own know enough or be resolute enough either to solve the problem or to ground the plane. Especially given the potential for loss of life that was foreseeable to Garrett and Phoenix, there was sufficient evidence that the negligence of Garrett and that of Phoenix were proximate causes of the crash.

*McLaughlin v. Mine Safety Appliances Co.*, 11 N.Y.2d 62, 226 N.Y.S.2d 407, 181 N.E.2d 430 (1962), and *Boltax v. Joy Day Camp*, 67 N.Y.2d 617, 499 N.Y.S.2d 660, 490 N.E.2d 527 (1986), do not require a different result. *Boltax* is distinguishable because there was no pattern of constant consultation on the problem, the situation was not one of **[**39]** inherently extreme danger that required expertise to fathom, and the "intervening" actor was the plaintiff himself. While the discussion in *McLaughlin* might be read to suggest that an intervening actor's gross negligence is a superseding cause that relieves the original negligent actor from liability, *see* 11 N.Y.2d at 71, 226 N.Y.S.2d at 414, the more recent New York cases discussed above, holding that reckless, intentional, and even criminal intervening acts are not superseding causes when they are foreseeable, indicate that such a reading would not accurately reflect current New York law. In any event, *McLaughlin* was a case in which the court found that the intervening act was entirely unforeseeable. There the product's container bore a warning as to the product's proper use; the intervening actor had been advised orally by the manufacturer's representative of the proper manner of use, and had received a formal demonstration of proper use. Yet the intervening actor removed the product from its carton before handing it to another person to use, thereby preventing the user from reading the manufacturer's warning, gave no oral warnings of his own to the user, and stood watching **[**40]** "callously" as the product was administered in precisely the manner proscribed by the manufacturer's warnings. Simply put, the court found this conduct so antithetical to the purpose of warnings as to be unforeseeable. In contrast, in the present case TGA in no way either refused to follow warnings or removed safety protections, for Garrett and Phoenix neither gave such warnings nor provided such protections.

Accordingly, the issue of proximate cause was properly submitted to the jury and no basis appears for setting aside the jury's findings.

D. *Miscellaneous Arguments Relating to Liability*

Defendants' other challenges to so much of the judgment as holds them liable to Woodling do not warrant discussion. Garrett's arguments in support of a new trial are moot since Garrett urged such relief only if we upheld the contentions of TG and TGA that they were entitled to judgment as a matter of law. The arguments of TG and TGA that they are entitled to a **[*557]** new trial on grounds of trial error -- such as their contention that, in connection with TG's alleged misrepresentations as to its control of TGA, the court should not have submitted to the jury an interrogatory asking who operated **[**41]** the Jetstar -- are baseless.

III. DAMAGES

Both sides contend that there was error in the calculation of the damages to which Woodling was entitled. Woodling contends principally that the trial judge erred in allowing the jury to deduct projected

income taxes from its estimates of Albert Woodling's future earnings, in allowing the jury to use two percent as an after-inflation investment return rate in determining the present value of future lost earnings, and in failing to award prejudgment interest on future as well as past losses. TG and TGA contend that the court should have ordered Woodling to pay them interest on the $250,000, returned by Woodling in order to rescind the Release agreement, for the period during which she had the use of that money. Other defendants contend that the court erred in awarding prejudgment interest dating back to Albert Woodling's death on the total amount awarded for past losses although those losses were suffered at various times after his death. We find merit only in the contentions that the jury should not have been allowed to deduct income taxes from Albert Woodling's lost future earnings, that the court should not have awarded prejudgment interest **[**42]** on the undiscounted prejudgment losses for the entire prejudgment period dating back to Albert Woodling's death, and that Woodling should pay TG interest on the $250,000 for the period during which she had use of that money prior to her rescission of the Release agreement.

A. *The Deduction for Future Income Taxes*

With respect to the amount Woodling was entitled to recover as lost support, the trial court admitted evidence as to the likely amount of income tax for which Albert Woodling would be liable on his anticipated gross earnings and instructed the jury that it should deduct such likely income taxes from Albert Woodling's gross income in calculating the amount to which Woodling was entitled for lost support. The evidentiary ruling and the instruction were erroneous.

Preliminarily, we note that an action for wrongful death is one created by state law and that state law controls the correct measure of damages for such a claim. *E.g., Feldman v. Allegheny Airlines, Inc.*, 524 F.2d 384, 386 (2d Cir. 1975) (state law governs, *inter alia*, reduction for likely future taxes and the discount rate adjusted for inflation to be used in discounting damages to present value); **[**43]** *Rhea v. Massey-Ferguson, Inc.*, 767 F.2d 266, 270 (6th Cir. 1985) (state law governs entitlement to prejudgment interest); *Jarvis v. Johnson*, 668 F.2d 740, 745-46 (3d Cir. 1982) (same), *Spinosa v. International Harvester Co.*, 621 F.2d 1154, 1158 (1st Cir. 1980) (state law governs effect of income tax on lost earnings); 1A *Moore's Federal Practice* para. 0.310, at 3139 (2d ed. 1985). Here, New York law governs the issues of what factors the jury should take into account in awarding damages.

In *Vasina v. Grumman Corp.*, a wrongful death action, we held that New York law does not allow evidence on the effect of taxes on lost income. 644 F.2d at 118. We see no persuasive reason why *Vasina* should be overruled. A ruling of one panel of this Circuit on an issue of state law normally will not be reconsidered by another panel absent a subsequent decision of a state court or of this Circuit tending to cast doubt on that ruling. *See Lubbock Feed Lots, Inc. v. Iowa Beef Processors, Inc.*, 630 F.2d 250, 261 (5th Cir. 1980); *Lee v. Frozen Food Express, Inc.*, 592 F.2d 271, 272 (5th Cir. 1979); *cf. Kremer v. Chemical Construction Corp.*, 623 F.2d 786, 788 (2d Cir. 1980) (on **[**44]** issues of federal law, one panel will not overrule another absent an intervening Supreme Court or Second Circuit decision that casts doubt on the validity of the first panel's decision), *aff'd on other grounds*, 456 U.S. 461, 102 S. Ct. 1883, 72 L. Ed. 2d 262 (1982). Since *Vasina*, no decision of this Court has **[*558]** altered the rule established there, and two New York cases have accepted the proposition that taxes need not be deducted from lost income, *see Sullivan v. Held*, 81 A.D.2d 663, 665, 438 N.Y.S.2d 359, 361 (2d Dep't 1981); *Louissaint v. Hudson Waterways Corp.*, 111 Misc. 2d 122, 127-30, 443 N.Y.S.2d 678, 679-83 (Sup. Ct. N.Y. Co. 1981), *aff'd mem.*, 88 A.D.2d 1110, 452 N.Y.S.2d 472 (1st Dep't 1982). While we note that a contrary view was taken in *Pellegrino v. State*, 128 Misc. 2d 757, 490 N.Y.S.2d 719, 720-21 (Ct. Cl. 1985), *aff'd on other issues*, 121 A.D.2d 612, 503 N.Y.S.2d 865 (2d Dep't 1986), we regard this decision of a single trial judge of a court of limited jurisdiction as less persuasive than the decisions of the Appellate Division and New York Supreme Court in *Sullivan* and *Louissaint*.

In any event, we find no merit in defendants' argument that *Vasina* was wrongly decided **[**45]** because it read *Coleman v. New York City Transit Authority*, 37 N.Y.2d 137, 371 N.Y.S.2d 663, 332 N.E.2d 850 (1975), as barring not only jury instructions on the nontaxability of damages awards but also as barring evidence on the effect of taxes on lost income. Although the issue in *Coleman* was the instructions given to the jury, the *Coleman* court, in finding the instructions not erroneous, cited with approval a number of cases that addressed only the evidentiary issue, *e.g., Petition of*

*Marina Mercante Nicaraguense, S.A.*, 364 F.2d 118, 125-26 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005, 87 S. Ct. 710, 17 L. Ed. 2d 544 (1967); *McWeeney v. New York, N.H. & H. R.R. Co.*, 282 F.2d 34, 38-39 (2d Cir.), *cert. denied*, 364 U.S. 870, 81 S. Ct. 115, 5 L. Ed. 2d 93 (1960).

In sum, we conclude that the district court erred in allowing evidence on the effect of income taxes on Albert Woodling's anticipated future earnings and in instructing the jury to take such taxes into account in assessing damages.

The jury's consideration of social security taxes is governed by the same principles. Although the trial court did not instruct the jury that it should deduct social security taxes, the court did permit the introduction of evidence as to such taxes, **[**46]** and it denied Woodling's request that the jury be instructed not to consider such taxes. This evidence should have been excluded and the jury should not have considered this factor.

There was substantial dispute at trial as to both what proportion of his earnings Albert Woodling would have been able to use as support for his family and what his income tax liabilities on his earnings would have been. Since there was no special interrogatory to the jury revealing the amount the jury deducted for taxes, we cannot determine the extent to which the jury's $750,000 award for lost support ($150,000 for past, $600,000 for future) was affected by the improper consideration of income or social security taxes. Thus, this facet of the damage claim must be retried. However, since the jury answered interrogatories that distinguished between the amounts awarded for lost support and those awarded for loss of services and loss of fatherly care and guidance, there need be no new trial as to the amounts recoverable for lost services, care, and guidance. *See Martell v. Boardwalk Enterprises, Inc.*, 748 F.2d 740, 756 (2d Cir. 1984).

B. *The Proper Discount Rate*

At trial, Woodling's expert testified **[**47]** that the present value of an award of damages should be calculated by using a one percent discount rate. The trial court instructed the jury that it should determine what figure was appropriate and that the decisions of this Court had suggested that a 1 1/2 to 2 percent rate would be appropriate. Woodling contends that the instruction was error and that the jury should have been told to accept her expert's one-percent figure. We disagree.

On damages issues as on liability issues, the trier of fact need not accept expert testimony even if uncontradicted. *See, e.g., Sartor v. Arkansas Natural Gas Corp.*, 321 U.S. 620, 627-28, 88 L. Ed. 967, 64 S. Ct. 724 (1944); *The Conqueror*, 166 U.S. 110, 131-33, 41 L. Ed. 937, 17 S. Ct. 510 (1897); *Commercial Casualty Ins. Co. v. Roman*, 269 N.Y. 451, 456-57, 199 N.E. 658 (1936). Thus, it was not error to refuse to instruct **[*559]** the jury that it must accept Woodling's expert's view.

Further, since the court clearly instructed the jury that it was free to determine what was the appropriate rate and to use that rate, it was not error to state that a 1 1/2 to 2 percent rate had been approved by this Court. *See McCrann v. United States Lines, Inc.*, 803 F.2d 771, 775 (2d Cir. 1986) (in cases governed **[**48]** by federal law, trier of fact applying "an adjusted discount rate [is] free to use 2% where the evidence of a more appropriate rate is unconvincing"); *Doca v. Marina Mercante Nicaraguense, S.A.*, 634 F.2d 30, 34-40 (2d Cir. 1980), *cert. denied*, 451 U.S. 971, 101 S. Ct. 2049, 68 L. Ed. 2d 351 (1981). It is clear that under New York law, in "computing damages for wrongful death or diminished earning capacity resulting from injury," lost future earnings are discounted, *O'Brien v. O'Brien*, 66 N.Y.2d 576, 588, 498 N.Y.S.2d 743, 749, 489 N.E.2d 712 (1985); *see Richards v. South Buffalo Ry Co.*, 54 A.D.2d 310, 314, 388 N.Y.S.2d 479, 482 (4th Dep't 1976); *Zaninovich v. American Airlines, Inc.*, 26 A.D.2d 155, 159, 271 N.Y.S.2d 866, 871 (1st Dep't 1966) (Breitel, *J.*); *Greck v. New York Central R.R. Co.*, 21 A.D.2d 776, 777, 250 N.Y.S.2d 992, 993 (1st Dep't 1964) (reversing for failure to discount to present value), and though the New York Court of Appeals has not yet ruled what the discount rate as adjusted for inflation should be, we have seen no reason to expect that the state courts would use a rate lower than two percent, *cf. Richards v. South Buffalo Ry. Co.*, 54 A.D.2d at 314, 388 N.Y.S.2d at 482 (using 4% discount **[**49]** rate). Thus, it was not error for the district court to allow use of the two-percent rate instead of the one-percent rate advocated by Woodling's expert.

We have considered plaintiff's other challenges to the discount rate instruction and find them to be without merit.

C. *The Proper Computation of Prejudgment Interest*

Both sides challenge the district court's calculation of prejudgment interest. The court awarded such interest on all of the sums awarded for prejudgment losses, for the entire prejudgment period dating back to Albert Woodling's death. Woodling urges affirmance of this award as far as it goes but contends that the court should have awarded her prejudgment interest on postjudgment losses as well. Defendants oppose this contention and argue further that, since the past losses were suffered at various times between the accident and the entry of judgment, the court should either have calculated prejudgment interest on each item of prejudgment loss only from the time of its occurrence, or have calculated interest on the sum of such losses from an intermediate date between the accident and the judgment. We find greater merit in defendants' arguments than in those of Woodling.

**[**50]** 1. *Postjudgment Losses*

EPTL § 5-4.3 provides, in part, that "interest upon the principal sum recovered by the plaintiff from the date of the decedent's death shall be added to and be a part of the total sum awarded." Woodling contends that this provision required the district court to include in the judgment an award of interest on all of her losses, whether or not suffered prior to the entry of judgment. Defendants, on the other hand, argue that our decision in *Lin v. McDonnell Douglas Corp.*, 742 F.2d 45, 51-52 (2d Cir. 1984) ("*Lin*") forbade the award of prejudgment interest for postjudgment losses. Although we are uncertain of the correctness of the fundamental assumption of *Lin*, we conclude that since the facts here matched that assumption the *Lin* holding should have been applied in the present case.

In *Lin* we ruled that a plaintiff was not entitled to prejudgment interest on postjudgment losses, stating that

> the purpose of the [wrongful death] statute is to compensate for "'pecuniary injuries' suffered by the distributees of decedent's estate." *Parilis v. Feinstein*, 49 N.Y.2d 984, 985, 429 N.Y.S.2d 165, 406 N.E.2d 1059 (1980). The prejudgment **[**51]** interest provision implements this goal by ensuring that the distributees are **[*560]** compensated for the time value of the income stream the decedent would have earned between death and the entry of judgment . . . Were prejudgment interest applied to the component of the award intended to compensate the plaintiff for postjudgment losses, plaintiffs would effectively receive a double recovery.

742 F.2d at 51-52. The assumption underlying this reasoning was that, when the factfinder discounts the award for future losses to account for the income that can be earned on an immediate lump sum award, it discounts back only as far as the date of its decision, not back to the date of the decedent's death. *See id.* at 51-52 & n.8. If the award of damages for losses that have yet to occur is not discounted for that earlier period from the date of death to date of decision, then an award of interest for that earlier period would not compensate any loss but would give the plaintiff a windfall. Since the goal of the wrongful death statute is to compensate the decedent's distributees for their pecuniary loss, *see* EPTL § 5-4.3; *Parilis v. Feinstein*, 49 N.Y.2d 984, 985, 429 N.Y.S.2d 165, 166, 406 N.E.2d 1059 **[**52]** (1980); *Rosenfeld v. Isaacs*, 79 A.D.2d 630, 630-31, 433 N.Y.S.2d 623, 624-25 (2d Dep't 1980), Lin's view, *i.e.*, that when the future loss award is discounted only to date of judgment there should be no prejudgment interest on those future losses, is correct. *Cf. Hollwedel v. Duffy-Mott Co.*, 263 N.Y. 95, 103-07, 188 N.E. 266 (1933) (under former N.Y. Civ. Prac. Act § 480, discharged employee cannot receive prejudgment interest on undiscounted lost wages from date of breach of contract as this would lead to overcompensation); *Petition of City of New York*, 332 F.2d 1006, 1008 (2d Cir.) (to the extent damage award already compensates for delay, there should be no prejudgment interest), *cert. denied*, 379 U.S. 922, 85 S. Ct. 277, 13 L. Ed. 2d 335 (1964).

Although we have found no clear discussion in the cases, it appears that the prior practice in wrongful death cases may have been to discount the plaintiff's postjudgment losses all the way back to the decedent's death, in which case, the award of prejudgment interest starting from the same date is needed to provide full compensation for the loss. *See In re Petroleum Tankers Corp.*, 204 F. Supp. 727, 731-32, 735-36 (S.D.N.Y. 1960); *cf. Hollwedel* **[**53]** *v. Duffy-Mott Co.*, 263 N.Y. at 103-07. Assuming that the inflation-adjusted discount rate is based on the legal rate of interest, which is used in calculating prejudgment interest, this practice

reaches precisely the same result as *Lin. See In re Air Crash Disaster Near Chicago, Ill.*, 644 F.2d 633, 643-46 (7th Cir. 1981).

We decline Woodling's invitation to abandon *Lin* on the basis that a recent New York Appellate Division decision, *Soulier v. Hughes*, 119 A.D.2d 951, 501 N.Y.S.2d 480 (3d Dep't 1986), has rejected it, since it is far from clear that *Soulier* achieves a result different from that in *Lin*. The terse statement in *Soulier* "declin[ing] to adopt [Lin's] reasoning," *id.* at 954, 501 N.Y.S.2d at 482, was unaccompanied by a disclosure of the method of discounting used in that case or of that court's reasoning. If the *Soulier* postjudgment damage award was discounted to the date of the decedent's death, *Soulier* reaches the same result achieved by *Lin*. If the *Soulier* award was discounted only to the date of the judgment, the methodology does not appear to conform to New York practice, the result was a double recovery that does not **[**54]** conform to the compensatory goal of the EPTL, and the court has provided no reasoning as to why this was the proper result. In light of our inability to determine whether the methodology used was consistent with that envisioned by *Lin*, and in light of the absence of any reasoning in support of the result produced if the methodology used was inconsistent with *Lin* and apparently inconsistent with prior New York practice, we conclude that *Soulier* is an inappropriate basis on which to determine that *Lin* is inconsistent with New York law.

In the present case, since the jury was instructed to discount its award for future losses only back to the date of its decision, the court should not have awarded prejudgment interest on those losses.

**[*561]** 2. *Prejudgment Losses*

The purpose of a prejudgment interest award is to remedy the delay in compensating a plaintiff for a loss. To this end, CPLR § 5001(b) provides that

> interest shall be computed from the earliest ascertainable date the cause of action existed, except that interest upon damages incurred thereafter shall be computed from the date incurred. Where such damages were incurred at various times, interest shall be computed **[**55]** upon each item from the date it was incurred or upon all of the damages from a single reasonable intermediate date.

This section applies to lost earnings recovered in tort suits. *See Loeb v. Teitelbaum*, 112 Misc. 2d 1039, 1041, 448 N.Y.S.2d 391, 393 (N.Y. Civ. Ct. 1982) (lost earnings recovered in tort suit for false arrest and malicious prosecution).

Since Woodling's cause of action for wrongful death accrued upon Albert Woodling's death, and Woodling's claim for lost support is derived from Albert Woodling's lost earnings over the years, § 5001(b) was applicable to the recovery on the claim for prejudgment lost support. Section 5001(b) was also applicable to the recovery on the claims for past loss of fatherly care and guidance and past loss of services since under EPTL § 5-4.3 these are claims for "pecuniary injuries." Such pecuniary injuries are in the nature of deprivations of property, *see Estate of Gary*, 79 Misc. 2d 419, 420, 358 N.Y.S.2d 488, 490 (Surr. Ct. Nassau Co. 1974); N.Y. EPTL § 5-4.3 Rohan's Practice Commentary, at 497 (McKinney 1981) (pecuniary injury is deprivation of pecuniary benefits that plaintiff had reasonable expectation of receiving), and CPLR § **[**56]** 5001 applies to interest on claims for deprivation of property. *See* CPLR § 5001(a); *Mallis v. Bankers Trust Co.*, 717 F.2d 683, 694-95 (2d Cir. 1983) (§ 5001 applies to tortious interference with tangible and intangible property rights). Accordingly, § 5001(b) did not authorize the court to award prejudgment interest on the total amount of Woodling's prejudgment loss dating back to the date of Albert Woodling's death.

Section 5001(b) provides two methods for avoiding overcompensating the plaintiff when prejudgment losses have occurred over a period of time: interest may be computed from the various dates on which the losses occurred, or it may be computed on all prejudgment losses "from a single reasonable intermediate date." CPLR § 5001(b); *see Esquire Radio & Electronics, Inc. v. Montgomery Ward & Co.*, 804 F.2d 787, 796 (2d Cir. 1986). On remand, the district court should recalculate the prejudgment interest on the awards for past loss of fatherly care and guidance and past loss of services in a manner consistent with one of these methods. Following a new trial with respect to the claim for lost support, required in Part III.A. above, the interest on an award for lost **[**57]** past support should also be calculated in like manner.

D. *TG's Entitlement to Interest on the $250,000 Release Payment*

Finally, we turn to TG's argument that in order to obtain rescission of the Release agreement, Woodling should have been required not only to return to TG the $250,000 she had received as consideration for signing the Release, but also to pay TG the legal rate of interest on that amount for the period during which she retained it. We find merit in the contention that Woodling should disgorge whatever interest she earned on the money, up to the legal rate of interest.

A plaintiff seeking rescission of a contract must disgorge "the fruits of the bargain." *Pacelli Brothers Transportation, Inc. v. Pacelli*, 456 A.2d at 330; *see Kavarco v. T.J.E., Inc.*, 478 A.2d at 261 (party rescinding contract renounces "any property obtained pursuant to the contract" and rescission should place both parties "as nearly as possible, in the same position as existed just prior to execution of the contract"). Such "fruits" include benefits derived from possession of the property conveyed, *see Duksa v. City of Middletown*, 192 Conn. 191, 472 A.2d 1, 4, 7 (1984); Restatement **[**58]** (Second) of Contracts § 384 comment *a*, such as interest on moneys conveyed, *see Marr v. Tumulty*, 256 N.Y. 15, 21-22, 26, **[*562]** 175 N.E. 356 (1931) (Cardozo, *C.J.*); *Thomas v. Beals*, 154 Mass. 51, 27 N.E. 1004, 1005 (1891) (Holmes, *J.*); Restatement (Second) of Restitution § 29 (Tent. Draft No. 1, 1983); Restatement of Restitution § 159(1)(a) (1937), or net profits from a conveyed business, *see Vitale v. Coyne Realty, Inc.*, 66 A.D.2d 562, 564, 414 N.Y.S.2d 388, 390 (4th Dep't 1979).

As to the rate of interest that must be paid on a sum returned in order to obtain rescission, we have discovered no pertinent Connecticut decision. When rescission is based on misrepresentation, the general rule appears to be that the maker of the misrepresentation is entitled to recover no more than the legal rate of interest and that he must bear the risk that the person to whom the misrepresentation was made may have earned less than that rate of interest. *See, e.g.*, Restatement of Restitution § 159 illustration 1; Restatement (Second) of Restitution § 29 comment *a* (Tent. Draft No. 1, 1983).

Accordingly, the district court should enter an order on remand requiring Woodling to pay TG interest **[**59]** on the $250,000 at the rate of interest she received or at Connecticut's legal rate, whichever is lower.

CONCLUSION

The judgment of the district court is vacated insofar as it (1) awarded $750,000 in damages for past and future loss of support, (2) awarded prejudgment interest on all past losses dating back to the date of Albert Woodling's death, and (3) failed to require Woodling to pay TG interest on the sum received in consideration for executing the rescinded Release agreement. In all other respects the judgment is affirmed. The matter is remanded to the district court for (1) a new trial with respect to the amount of damages to which Woodling is entitled for past and future loss of support, (2) recalculation of prejudgment interest on all awards for prejudgment losses in a manner consistent with this opinion, and (3) an order requiring Woodling to pay interest to TG as described above.

Plaintiff shall recover her costs of these appeals from TG, TGA, Garrett, and Phoenix. All other parties shall bear their own costs.

# TAB 16

1998 CarswellOnt 2784
Ontario Court of Justice, General Division

Vasquez v. Delcan Corp.

1998 CarswellOnt 2784, [1998] O.J. No. 2833, 38 C.C.E.L. (2d) 230, 80 A.C.W.S. (3d) 1027

# Gualberto Vasquez, Plaintiff and Delcan Corporation and Delcan International Corporation, Defendants

Swinton J.

Heard: June 15-18 and 23, 1998
Judgment: July 7, 1998
Docket: 96-CU-97193

Counsel: *D.B. Prentice* and *D. Condon*, for the Plaintiff.
*W.R. Gale*, for the Defendants.

Subject: Employment; Public

**Headnote**

**Conflict of laws --- Contracts — Choice of law — Where contract specifying law**

Plaintiff initiated action for wrongful dismissal — Action was dismissed — Plaintiff claimed employment contract was ruled by Venezuelan law — Plaintiff was hired by defendant for job in Venezuela — Plaintiff signed acceptance of employment form which stated law of location would govern employment — Overseas contract expressly provided that laws of Ontario would govern contract — Defendant dismissed plaintiff for cause, defined under contract — Overseas contract had greatest connection to Ontario and was governed by Ontario law — Defendant was based in Ontario, contract was entered in Ontario, plaintiff was paid in Canadian dollars, salary was deposited into Ontario bank and main task of plaintiff was to carry out procurement process of defendant in Ontario — Plaintiff failed to demonstrate that dismissal was contrary Venezuelan law or public policy of Ontario.

**Employment law --- Termination and dismissal — Termination of employment by employer — What constituting just cause (grounds for dismissal) — General**

Plaintiff initiated action for wrongful dismissal — Action was dismissed — Plaintiff was hired by defendant for job in Venezuela — Contract provided that termination for cause included rejection by client — Overseas client rejected plaintiff and defendant terminated plaintiff — Exercise of discretion, regarding personal compatibility, is subject to good faith and honesty — Rejection by client was normal grounds for dismissal on overseas projects — Evidence showed that defendant terminated plaintiff on this ground, as contract allowed, and for no other reason — Plaintiff failed to demonstrate bad faith on part of defendant.

**Employment law --- Termination and dismissal — Practice and procedure — Remedies — Reinstatement**

Plaintiff initiated action for wrongful dismissal — Action was dismissed — Plaintiff was hired by defendant for job in Venezuela — Plaintiff signed acceptance of employment, which stated employee could be terminated without cause and with payment in lieu of notice — Overseas contract stated that termination for cause included rejection by client — Overseas client rejected plaintiff and defendant terminated plaintiff — Plaintiff was given no job back in Ontario, but was paid $7,749 in lieu of notice — No breach of contract by defendant was demonstrated — Defendant terminated plaintiff for cause under overseas contract and without cause under acceptance of employment, as defendant was allowed to do.

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**Table of Authorities**

**Cases considered by *Swinton J.*:**

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*Gillespie Management Corp. v. Terrace Properties* (1989), 39 B.C.L.R. (2d) 337, 62 D.L.R. (4th) 221 (B.C. C.A.) — considered

*Greenberg v. Meffert* (1985), 50 O.R. (2d) 755, 18 D.L.R. (4th) 548, (sub nom. *Greenberg v. Montreal Trust Co.)* 9 O.A.C. 69, 7 C.C.E.L. 152, 37 R.P.R. 74 (Ont. C.A.) — considered

*Truckers Garage Inc. v. Krell* (1993), 3 C.C.E.L. (2d) 157, 68 O.A.C. 106 (Ont. C.A.) — referred to

*Vita Food Products Inc. v. Unus Shipping Co.*, [1939] 1 W.W.R. 433, [1939] A.C. 277, [1939] 1 All E.R. 513, 48 C.R.C. 262, [1939] 2 D.L.R. 1 (Canada P.C.) — applied

*Wallace v. United Grain Growers Ltd.*, 152 D.L.R. (4th) 1, 219 N.R. 161, 123 Man. R. (2d) 1, 159 W.A.C. 1, 97 C.L.L.C. 210-029, [1997] 3 S.C.R. 701, 36 C.C.E.L. (2d) 1, 3 C.B.R. (4th) 1 (S.C.C.) — considered

**Statutes considered:**

*Venezuelan General Labour Act*
Generally — considered

Art. 10 — considered

Art. 98 — considered

Art. 99 — considered

Art. 102 — considered

Art. 108 — considered

Art. 110 — considered

Art. 186 — considered

ACTION by employee for wrongful dismissal.

***Swinton J.*:**

1 The plaintiff Gualberto Vasquez has brought an action for wrongful dismissal against his former employer, Delcan Corporation and Delcan International Corporation.

2 The plaintiff is a 48 year old Professional Engineer trained in Chile, and a member of the Association of Professional Engineers of Ontario since 1989. In 1993, he began his relationship with Delcan Corporation, a firm of consulting engineers which provides services for the implementation of infrastructure projects, mainly in the areas of transportation and environment. Commencing February 4, 1993, he was hired on contract through TES Contract Services Inc., an employment agency, to work on a feasibility study related to Margarita Island in Venezuela. His fluency in Spanish and his background in municipal engineering

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were important qualifications in his selection for the project. The contract continued to October 8, 1993, when he was offered full time employment with Delcan.

3 At that time, Mr. Vasquez signed an Application for Employment form, and he received a letter dated October 7, 1993 offering him a six month probationary contract. As well, he signed an Acceptance of Employment Form on October 18, 1993, which stated that he could be terminated at any time without cause on being provided with the greater of the period of notice required by provincial employment standards legislation applicable to the location of employment, or four weeks notice plus one week's notice for each year of service to a maximum notice period of 12 weeks. The law of that agreement was stated to be the law of the location of employment. Sometime in February, 1994, Mr. Vasquez signed a document indicating that he had received a copy of the Employee Manual, although he testified that he never actually received the document. He became a permanent employee on April 11, 1994, when he received a further letter, making his start date retroactive to October 12, 1993. This letter stated that the agreement would be governed by the laws of Ontario.

4 Mr. Vasquez began what was to be a six month assignment in Maracaibo, Venezuela in October, 1994, where he managed a group of Venezuelan engineers and one Canadian engineer. Prior to that assignment, he signed an Overseas Fixed Term Agreement with Delcan International, the subsidiary of Delcan which employed all employees working outside Canada or the United States. While he was in Maracaibo, his family remained in Canada.

5 In early 1995, he was asked by Delcan if he would be willing to work in Venezuela on the Margarita Island project as the Resident Project Coordinator. The project was estimated to last from two to five years. After discussing this with his family, Mr. Vasquez indicated that he was interested. The project was attractive to the family, because it presented a good career opportunity for Mr. Vasquez and would allow the children to learn Spanish fluently, although the decision to move also imposed many burdens on the family, as they had to rent their house in Burlington, Mrs. Vasquez had to resign from her employment, and proper schools had to be found in Venezuela for the three children.

6 Mr. Vasquez negotiated the terms of his contract with Brian Henderson, then Vice-President of the Toronto Region. These terms were set out in another Overseas Fixed Term Agreement made with Delcan International. The document states that "the agreement will be interpreted under the laws of the province of Ontario, Canada, except as expressly provided herein". The Agreement also states that the Delcan Employee Manual will apply, and

> any conditions in the Company's contract with the Client or otherwise imposed by the Client with regard to the assignment of personnel to the project will be interpreted as if they were part of this agreement unless stated otherwise herein.

7 The terms included a salary of $76,000. per year; $2,000 per month for living expenses; $2,000 and $1,500. to be paid for mobilization and demobilization respectively; and a schooling allowance for each of the three children of up to $5,000 per year. The term of the contract is stated to be 24 months commencing June 1, 1995, and renewable for a further term. While Mr. Vasquez gave evidence that he expected the contract to last for at least two years, he was aware of the termination provisions of the contract set out below, which allow termination for cause if the client rejected him, and he discussed with his wife the possibility that the assignment would not last the full period.

8 Article A.4 deals with "termination of agreement". It sets out terms for dismissal with cause, which included the following:

> (a) With Cause: The Company may terminate this agreement at any time for just cause without notice or compensation to the Employee. Notwithstanding the generality of the foregoing, the Employee expressly agrees that the following reasons shall constitute just cause:
>
> . . . . .
>
>> (2) rejection by the Client or a determination by the Company that the Employee is unsuitable for employment or is unable to perform any part of or all of the duties required under Section A.2.
>
> The existence of just cause as described in (1) and (2) above shall be determined in the sole discretion of the Company. In the event the Agreement is terminated for just cause, the Company may pay for the costs of repatriation in its sole discretion.

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(e) The parties agree and acknowledge that upon termination of this agreement as contemplated herein, the Employee shall return to the same or substantially similar employment position in the location previously held before the Commencement Date of this agreement. Particularly, the terms and conditions of the Employee's employment contract with the Company prevailing before the Commencement Date of this agreement, including but not limited to, the provisions in the Delcan Employee Manual and the terms and conditions in the Acceptance of Employment Form and Application Form (if applicable), shall continue in full force and effect after termination of this agreement, as may have been amended from time to time by the Company during the term of this agreement.....

9 Mr. Vasquez moved to Margarita Island around mid July, 1995, and his family moved there shortly after.

10 The purpose of the Margarita Island project was to rehabilitate the municipal sewage and water treatment infrastructure of that area. Delcan had entered into a contract with the Ministry of Environment and Renewable Natural Resources of the Government of Venezuela ("MARNR") in December, 1994 to provide services in procuring necessary equipment and materials for the rehabilitation. The contract was for $26,880,000 Canadian, with funding provided through a loan to Venezuela from the Export Development Corporation of Canada ("EDC"). Article 19 of that agreement states, in part, that the consultant, Delcan, "will comply with all the national, state, and municipal laws related to its obligations according to this Contract".

11 A contract between the Government of Venezuela, Delcan International Corporation, and the Export Development Corporation dated December 12, 1994 governed disbursement procedures. It provided that 85% of the funds were to be used for equipment and supplies. The remaining 15% could be used for the purchase of local goods and services in Venezuela. Delcan International also entered a Memorandum of Understanding with EDC, whereby Delcan promised to comply with EDC policy and procedures, including the requirement that 90% of the funds for equipment and supplies would be spent in Canada.

12 The contract with the Government of Venezuela contemplated a fairly complex system for procurement, which started with a letter of Request for Quotation from the Venezuelan engineering team working on the project. This would specify the equipment or material needed, and be sent through Mr. Vasquez as Resident Project Coordinator. One of his tasks was to review the specifications for completeness before sending the request to Toronto, where it would be translated into English, and then circulated to approved lists of suppliers by Delcan in order to obtain at least three bids. When bids were received, Delcan would choose the one which best met the client's specifications, at the lowest price, and then send a Proforma to the Venezuelan consulate in Toronto and the Board of Trade. After obtaining certification from them, the Proforma was translated and sent to both the Venezuelan government office in New York and to Venezuela. In Venezuela, the Proforma had to be approved by the necessary officials on the project, as well as the Office of the National Comptroller. Only then, could the equipment or material be ordered. This process took at least three to four months, and often met with delays, because more information was needed about the specifications or the product.

13 With respect to local expenses, Mr. Vasquez's role was to ensure that invoices related to the project were signed by the client to indicate approval. If these related to expenses incurred by Delcan, reimbursement was then sought from EDC. Mr. Vasquez indicated in testimony that he had more or less done his duties once the client signed the invoices.

14 Mr. Vasquez's first task on the Margarita Island project was to find office space for the project adequate for himself, the Venezuelan engineers and other staff. He made efforts to find suitable office space with the Project Advisor, Jose Paradela, a Vice-President of Delcan Corporation and Vice-President Latin America for Delcan International, who was based in Toronto. They eventually found suitable space in May, 1995, but it required extensive cleaning and renovations. The renovations took up a lot of Mr. Vasquez's time from mid-July, but they were completed by mid-August.

15 The Venezuelan team on the project was headed by Antonio Rodriguez, an engineer who was based in Caracas, and oversaw this and other projects for the Venezuelan government on a contract basis. Mr. Vasquez expressed a number of concerns about the use of funds for local expenditures, including the fact that Mr. Rodriguez and the other Venezuelan engineers were paid through Delcan, the interior decoration for the office was overseen by Mr. Rodriguez's daughter from Caracas, there were

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some questionable repairs done to Mr. Rodriguez's automobile, a computer disappeared, and the cleaning bill for the office seemed excessive.

16 Mr. Vasquez testified that he expressed concerns to Mr. Paradela several times respecting irregularities in some of the local expenses. He did not describe the expenses as "improper", but "exaggerated" or excessive. There is some disagreement about the response, with Mr. Vasquez indicating that Mr. Paradela said that the Venezuelans thought there was a well of money, and something would have to be done. However, Mr. Paradela denied this in his testimony, stating that he indicated it was the client's call as to how they wanted to spend their money.

17 There is no evidence that Mr. Vasquez indicated concerns to the Venezuelans on the project. The only concern expressed in writing to Delcan before the dismissal is a memo dated October 11, 1995 to Mr. Paradela, in which Mr. Vasquez notes that some office renovation expenses were excessive, in his opinion, but properly approved by the client, and "therefore, I could not have objections". It was only after notice of the termination of his assignment in Venezuela that he put further criticisms of the financial administration in writing.

18 Mr. Rodriguez became discontented with the pace of the procurement project, and sought a meeting with Mr. Paradela in late October. Mr. Paradela suggested that Mr. Henderson attend the meeting, given that he was in Venezuela at the time, and Mr. Paradela had just returned to Toronto. A meeting was held on October 30, 1995 in Caracas, at which Mr. Rodriguez expressed his concerns about the slow pace of the procurement process. Mr. Vasquez was present, and testified that nothing was said about his performance.

19 The evidence is not clear as to when Mr. Rodriguez indicated his opposition to working further with Mr. Vasquez. According to Mr. Henderson's testimony in chief, Mr. Rodriguez spoke to him after the meeting and expressed the view that the process could not function properly with Mr. Vasquez as Project Coordinator. In cross-examination, he conceded that he might have been in error, and Mr. Rodriguez may have communicated his opposition to Mr. Paradela, who then spoke to Mr. Henderson. In his examination for discovery, he had indicated that Mr. Rodriguez stated during the meeting that the facilitator function was not working.

20 Mr. Vasquez followed up the meeting with a letter on October 31 to Mr. Rodriguez, assuring him that efforts would be made to speed up the process and promising greater involvement of Delcan in decisions related to the request for Canadian equipment and supplies. Mr. Rodriguez responded by letter on November 14, stating that Mr. Vasquez misunderstood the client's needs. They did not want Delcan involved with decisions relating to materials and equipment requests; rather, they wanted the resident engineer to assume responsibility for reviewing the conformity of materials offered with the specifications for materials requested. Mr. Vasquez then replied, indicating that Mr. Rodriguez did not understand the procurement process.

21 Mr. Paradela testified that he had received a call from Mr. Rodriguez on October 31, stating that he wanted Mr. Vasquez off the job. Mr. Rodriguez indicated that he had not communicated this to Mr. Henderson because of the latter's unfamiliarity with the project and the degree of his fluency in Spanish, although Mr. Henderson claims fluency in that language.

22 Mr. Vasquez was notified through a telephone call from Mr. Henderson in Barbados on November 1, 1995. It is agreed that Mr. Henderson said that the client wanted Mr. Vasquez off the job, but Mr. Henderson also told Mr. Vasquez that the only possibility for him to stay was by approaching Mr. Rodriguez and trying to change his mind. The company agreed to pay for the Vasquezs' return to Canada. Mr. Vasquez testified that he was told that there was no job for him in Canada, although in his letter to Mr. Henderson dated November 21, 1995, he indicates his understanding that the company is *unlikely* to have a position in Canada.

23 Mr. Paradela telephoned shortly after, urging Mr. Vasquez to approach Mr. Rodriguez to try to resolve the problem by persuading Mr. Rodriguez that the relationship could work. He also advised Mr. Vasquez on how to approach Mr. Rodriguez - for example, by enlisting support from another of the Venezuelan employees, Mr. Aguilar.

24 Mr. Vasquez testified that until this point, no one had criticized his performance on the Margarita Island project, and this evidence was not contradicted by the company's witnesses. He felt unhappy about having to approach Mr. Rodriguez in what

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he described as a "submissive" manner, for he felt that this was undignified. He testified that he would not have approached Mr. Rodriguez if the company had not suggested it.

25 After several phone calls to Mr. Rodriguez's office, Mr. Vasquez was able to obtain an appointment for Monday, November 6. However, he cancelled that appointment and flew to Toronto to obtain legal advice, without telling the company officials his whereabouts.

26 He returned later that week, and met with Mr. Rodriguez around November 13. According to Mr. Vasquez, Mr. Rodriguez indicated that he had no professional or ethical complaints about Mr. Vasquez, but he just could not work with him because of a personality conflict. Therefore, Mr. Rodriguez did not change his mind about wanting Mr. Vasquez off the project. In a fax dated November 14, 1995, Mr. Vasquez confirmed that "The Venezuelan Ministry of Environment, MARNR maintained his decision, that is, to request my removal of the Project".

27 While Mr. Henderson asked Mr. Vasquez to remain in Margarita Island until mid-December, so that he could be replaced, Mr. Vasquez insisted on leaving quickly, because of fears for his family's safety. He mentioned this in a letter to Delcan on November 21, which also raised concerns about financial irregularities on the project.

28 Mr. Henderson testified that he then caused inquiries to be made by Diane Stone, who was responsible for the financial administration of all overseas projects. Following her report, he concluded that the statements about financial irregularities were unfounded. On November 24, 1995, he wrote Mr. Vasquez to that effect, and also gave notice pursuant to Article A.4(2) of the Overseas Agreement that Mr. Vasquez's employment was being terminated for cause - namely, rejection by the client. The letter also gave notice that there was no position available in Toronto, upon his return, and therefore, he was being terminated in accordance with paragraph 3(e) of the Acceptance of Employment Form. He was flown back to Toronto at the company's expense, while his family was flown to Miami and then to Chile, with open returns to Toronto. As their house was still rented, the family did not return to Canada until June, 1996. Mr. Vasquez was paid $7,749. in lieu of notice. He also received $1,500. for demobilization expenses, in accordance with the Overseas Agreement, although he claimed a larger sum for shipment of goods. He also claims, in this action, sums to compensate him for rent which he had pre-paid in Venezuela and furniture that he left behind and was unable to sell because the family left so quickly.

**The Issues**

29 There are a number of issues to be determined in this action:

1. Does the law of Venezuela apply to this contract, so as to confer remedies under Venezuelan labour law?

2. Was the employer in breach of the Overseas Fixed Term Agreement, either in terminating the contract as it did or in failing to offer the plaintiff employment in Ontario?

3. What are the remedies to which the plaintiff is entitled?

**The Applicable Law**

30 The Overseas Fixed Term Agreement states that it is to be interpreted under the laws of Ontario, except as otherwise expressly provided. Nevertheless, the plaintiff argues that Venezuelan law should apply in the circumstances.

31 In accordance with Canadian conflict of laws principles, courts respect the parties' express choice of the law to govern their contract, absent vitiating factors. In the leading case, *Vita Food Products Inc. v. Unus Shipping Co.*, [1939] A.C. 277 (Canada P.C.), the Privy Council held that the parties' expressed intention should determine the proper law of a contract, provided that the application of that law is not contrary to public policy, and the choice was *bona fide* and legal. This was rephrased by Adams J., in *Cardel Leasing Ltd. v. Maxmenko* (1991), 2 P.P.S.A.C. (2d) 302 (Ont. Gen. Div.), who relied on J.G. Castel, *Canadian Conflict of Laws* (2d ed., Toronto: Butterworths, 1986) for the proposition that courts will disregard the choice of a law expressly made to evade the system of law with which the transaction, objectively considered, is most closely connected.

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32 Here, the Overseas Fixed Term Agreement states expressly that it will be interpreted under the laws of Ontario, except as otherwise expressly provided herein. I accept that these words indicate an express choice that Ontario law shall govern that agreement.

33 The plaintiff argued that Venezuelan law was the proper law of the contract because the Acceptance of Employment form signed by Mr. Vasquez states that his employment shall be governed by the laws of the location where he was employed. However, that agreement can not apply to Mr. Vasquez's employment in Venezuela, given that the Overseas Agreement expressly states that this agreement "serves as a summary of all known conditions and details of the Employee's overseas employment". The Acceptance of Employment form did not govern the relationship until after the termination of the Overseas Fixed Term Agreement. At that point, in accordance with Article A.4(e), the employee was to return to employment in his previous location - in the case of Mr. Vasquez, Toronto. In accordance with the Acceptance of Employment form, following the termination in Venezuela, Mr. Vasquez was an employee of the Toronto region, and, again, Ontario law would apply to the employment contract.

34 It was also argued that Venezuelan law should apply because of the employer's promise to abide by Venezuelan laws in its contract with the government, and the following phrase in the Overseas Agreement, "...any conditions in the Company's contract with the Client or otherwise imposed by the Client with regard to the assignment of personnel will be interpreted as if they were part of this agreement unless stated otherwise herein". There are several problems with this argument: first, the Overseas Agreement expressly states that Ontario law is chosen to interpret the agreement; second, the obligations of the employer incorporated from the other contract are obligations related to the assignment of personnel, not all parts of its other contract; third, even if the employer committed itself to the observance of Venezuelan laws in performing its obligations under that other contract, that commitment does not incorporate those laws in the contracts of employment with its employees, especially given the express choice of Ontario law.

35 While the parties' express choice of law may be disregarded in certain circumstances, as set out above, the choice here was not an attempt to avoid the system of law with which the transaction was most closely connected. An examination of the facts shows that Ontario is, in fact, the jurisdiction with which the transaction is most closely connected. Mr. Vasquez was an employee of Delcan and Delcan International, both Ontario-based companies; the agreement was entered into in Toronto; he had a right to return to employment in Toronto on termination of the overseas assignment; he was paid in Canadian dollars deposited to his bank in Burlington, his main task was to facilitate the procurement process carried out by Delcan in Canada, and his supervisors were based in Toronto. Therefore, Ontario law is the law with the greatest connection to the contract, even though Mr. Vasquez physically performed his duties in Venezuela.

36 Nevertheless, courts have refused to enforce a contract, legal under the proper law of contract, where the plaintiff relies on actions illegal in the place of performance of the contract. In *Gillespie Management Corp. v. Terrace Properties* (1989), 39 B.C.L.R. (2d) 337 (B.C. C.A.) at 343, 344, the plaintiff sought to recover monies in British Columbia under a contract governed by British Columbia law, relying on acts performed in Washington which were illegal in that state, because he had lacked the necessary real estate broker's licence. On grounds of public policy, the Court refused to sustain the plaintiff's claim based on its illegal acts in another jurisdiction.

37 Similarly, in *Cardel, supra*, Adams J. refused to allow the plaintiff in an Ontario action to sue for outstanding rental payments after it had seized a leased automobile in British Columbia, even though the contract specified Ontario law as the proper law of the contract, and Ontario law permitted both remedies. British Columbia law required an election between the two remedies. The Agreement specifically stated that where any provision of the contract contravenes the law of any province where the agreement is to be performed, so as to be invalid or unenforceable, the provision was deemed not to be part of the agreement. Adams J. referred to this clause and concluded that the contract had its most substantial connection with British Columbia. As the law of that province extinguished the right to recover the amounts owing if the vehicle was seized, he refused the plaintiff's claim in Ontario.

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38 Here, the plaintiff argues that the defendants acted contrary to the Venezuelan General Labour Act in dismissing him prior to the completion of his fixed term contract. Expert evidence was given by two Venezuelan labour lawyers about the application of this Act, Carlos Teran for the plaintiff and Dr. Rafael Echeverria for the defendants. According to Article 10 of the Act, the provisions of this law are of public order and of territorial application. They rule both Venezuelan and foreign citizens in relation to work performed or agreed to be rendered in Venezuela, and, under no circumstances, may they be waived or relaxed through private covenants.

39 Article 98 states that "[a]n employment relationship may terminate by means of dismissal, resignation, mutual agreement between the parties, or by causes beyond their will." Both experts agreed that the Venezuelan labour law applies to work performed in Venezuela, even if the proper law of the contract was stated to be that of another jurisdiction. They also agreed that the parties can, by mutual agreement, agree on the terms of termination of their relationship, so long as the conditions do not go beyond the labour law. However, they disagreed on what terms would go beyond that law.

40 The plaintiff argued that the term in the Overseas Agreement allowing termination for cause because of rejection by the client was illegal. It was his position that the agreement should not be enforced in Ontario because of its illegality in the place of performance. Mr. Terán was of the opinion that Article 102 contains an exhaustive list of the actions deemed to be justified causes for dismissal, and the General Labour Act contains minimum standards which the employee cannot waive. In his view, in accordance with Article 108, an employee on a fixed term contract who is dismissed without justification has a right to salary, broadly defined, for the rest of the fixed term - here, for the remainder of the 24 month term. In contrast, Dr. Echeverria testified that the parties can express their will and agree to terms, such as what constitutes grounds for termination, in accordance with Articles 98 and 186.

41 Having considered the evidence of both experts, I conclude that there was no illegality in the termination of the Overseas Agreement. Therefore, there is no basis to refuse to apply Ontario law, as specified in the Agreement, on grounds of public policy. First, I do not find that there is a "dismissal without justification" here within Article 110, which deals with fixed term agreements. "Dismissal" is defined at the commencement of Article 99 as "the employer's manifestation of its will to bring to an end the employment relationship binding it to one or more workers". When Delcan terminated the Overseas Agreement, it did not thereby terminate the employment relationship with Mr. Vasquez; rather, it brought to an end to overseas assignment, and Mr. Vasquez reverted to his employment status with Delcan in Toronto. Dr. Echeverria was of the opinion that a contract with the provisions for termination in the Overseas Agreement was valid under the Venezuelan law, and Mr. Teráan also conceded that parties could agree to the termination of an overseas assignment, provided that the employee returned to his prior employment status at conditions equal to the ones enjoyed under the fixed term agreement. Therefore, I do not find that there was a contravention of the Venezuelan law.

42 In the alternative, even if the parties' consent to the termination of the Overseas Agreement on rejection by the client was contrary to Venezuelan law, this is not a situation where the application of the proper law of the contract - Ontario law - is contrary to public policy. This is not a situation, as in *Gillespie* or *Cardel, supra*, where the plaintiff seeks to rely on acts illegal in the place of performance in enforcing the contract in another jurisdiction. The Venezuelan labour law does not render the employment contract illegal if it contains terms less protective than the labour law; rather, it prohibits reliance on terms less beneficial to the employee than those in the law and ensures the employee certain monetary relief and, in some circumstances, reinstatement to employment. The Act also provides enforcement mechanisms, which include the intervention of various actors within the Venezuelan system for the administration of justice, including the Labour Stability Judge and administrative authorities. Mr. Vasquez clearly could have sought relief in Venezuela, but he chose not to do so. In the circumstances, it is not contrary to Ontario public policy to apply Ontario law, given that Ontario is the place with the strongest connection to the parties' employment relationship, and there was no illegality in the performance of the employment contract.

43 Therefore, this case falls to be determined only in accordance with Ontario law, as provided in the two relevant agreements.

**Breach of Contract**

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44 The plaintiff argues that the employer has breached the Overseas Agreement in dismissing him, because the employer failed to demonstrate good faith in its actions. Even though the Agreement states that it can be terminated for cause if the client rejects the employee, the plaintiff argues that this clause must be applied in good faith (see, for example, *Greenberg v. Meffert* (1985), 7 C.C.E.L. 152 (Ont. C.A.) at 152). Here, it is argued that the plaintiff may have been dismissed because of the concerns he voiced about financial irregularities, rather than his performance, or because the employer wanted to make him a scapegoat in a procurement process that was not proceeding as quickly as desired by the Venezuelans.

45 In *Greenberg* , the Court of Appeal noted that matters to be determined on the basis of taste, sensibility or personal compatibility are likely to be measured by a subjective standard, but such exercises of discretion are still subject to an obligation of good faith and honesty (at 159). In that case, the Court held that the former employer of a real estate agent was required to act reasonably and in good faith in exercising its discretion regarding the payment of commission earned on listings acquired before the employment relationship ended. There was evidence of collusion between two employees to deprive the plaintiff of commission and to direct it to themselves, leading the Court to comment that the "patently improper conduct vitiated not only the reasonableness required in the objective criteria but the good faith and honesty required whether the discretion is objective or subjective" (at 162).

46 Here, while the results of the termination were harsh for the Vasquez family, there is no evidence of bad faith or dishonesty on the part of the employer, as in *Greenberg* , *supra*. According to the Overseas Agreement, which Mr. Vasquez signed for the Margarita Island project and which he had signed for Maracaibo earlier, rejection by the client is cause for termination. Mr. Henderson testified that this is a fairly normal clause in overseas agreements, since a great deal of the success of a project depends on the relationship of the client and the Delcan employee. The evidence is clear that the client, acting through Mr. Rodriguez, wanted Mr. Vasquez off the job. There is evidence from both Mr. Henderson and Mr. Paradela to that effect, and Mr. Vasquez, in his fax of November 14, 1995, confirms that the client does not want him on the project because of a personality conflict.

47 The evidence is insufficient to establish that the reason for Mr. Vasquez's dismissal was the fact that he raised concerns about financial improprieties. His concerns were not voiced to the Venezuelans, nor pursued in writing before termination of his assignment. Moreover, some of his concerns were clearly misguided - for example, the fact that the Venezuelan personnel were employed by Delcan and paid through the project. This was contemplated in the contract between Delcan and MARNR from the outset. With respect to the office expenditures, the Venezuelans were the ones who had to sign off, and once they did so, Mr. Vasquez acknowledged that he had no further role. On the evidence, I find that the client rejected Mr. Vasquez because of discontent with his performance of the facilitator function at Margarita Island and personality conflicts, and he knew this was so.

48 The plaintiff argues that the employer was still bound by a duty of good faith in exercising the power to terminate, and therefore, Mr. Henderson or Mr. Paradela should have intervened with Mr. Rodriguez and tried to explain that the difficulties in the project were due to start up problems and inevitable delays. Given the drastic consequences for the Vasquez family caused by the termination of the contract, that would have been a humane thing to do. However, the failure to intervene does not equate with "bad faith" by the defendants. In cases where the employer has been held to have abused its discretion, there is evidence that the employer acted for an ulterior motive or acted capriciously (see, for example, *Truckers Garage Inc. v. Krell* (1993), 3 C.C.E.L. (2d) 157 (Ont. C.A.); *Greenberg* , *supra* at 162). The evidence here indicates that the employer terminated the employment because the client rejected Mr. Vasquez - as the contract allowed it to do to meet the client's demands.

49 What the plaintiff seeks to do here is read in requirements to bind the company in exercising its discretion to terminate when the client rejects an employee, when the contract contains no such terms. The Supreme Court of Canada in *Wallace v. United Grain Growers Ltd.*, [[1997] 3 S.C.R. 701 (S.C.C.)] refused to imply into employment contracts an obligation of good faith that would govern the reasons for dismissal - that is, a requirement that dismissal must be for cause or legitimate business reasons (at 735). Nevertheless, the majority held that an employer had an obligation of good faith in the manner of dismissal - for example, an obligation not to press unfounded charges of cause or to act in an unacceptably harsh manner when terminating (at 742). Failure to comply with that obligation may extend the period of notice awarded for wrongful dismissal.

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50 Here, the employer had cause for termination of the Overseas Agreement, so *Wallace* is not applicable. The plaintiff has argued that the employer nevertheless breached its obligation in that agreement to return the plaintiff to a similar or substantially similar position in the previous location, and therefore, should not be able to rely on the termination provisions of the agreement because of the doctrine of fundamental breach.

51 This argument misconstrues the terms of the Overseas Agreement. With cause, the employer can terminate the Agreement, with the effect that the employment relationship resumes under the terms of the earlier agreement in the previous location. While the employee is said to be entitled to return to his previous employment or similar employment, the clause goes on to emphasize that the previous terms of employment apply. In this case, the terms of the Acceptance of Employment form came back into effect, and allowed the employer to terminate without cause on payment of the specified sums in lieu of notice. The employer paid for the return of the Vasquez family to Canada, and provided Mr. Vasquez with the amount owing in lieu of notice, as well as the $1,500. in demobilization expenses provided in the Overseas Agreement. In these circumstances, there has been no breach of the Overseas Agreement.

52 The plaintiff argued that the employer could not terminate under the Acceptance of Employment Form, because it contained specific provisions regarding regular performance appraisals and an opportunity to improve performance before termination. Mr. Vasquez testified that he had not received such appraisals. However, these provisions are not applicable, as they are relevant to a termination for cause based on poor performance. Here, the employer did not purport to terminate the employment for cause, but rather exercised the contractual right to terminate without cause and with payment in lieu of notice. Therefore, the lack of performance appraisals is not relevant.

53 Therefore, I find that there has been no breach of the Overseas Fixed Term Agreement, and Delcan also acted in compliance with the Acceptance of Employment form. While the Vasquez family has suffered a great deal of unhappiness and hardship as a result of the termination of Mr. Vasquez's employment, the defendants have acted in reliance on contractual documents to which Mr. Vasquez agreed and which he signed. The terms are not contrary to Ontario law, nor do I find that they are unenforceable because of the impact of Venezuelan law. Therefore, the action is dismissed. If the parties are unable to agree with respect to costs, I may be spoken to.

*Action dismissed.*

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# TAB 17

# CREDIT BIDDING IN CANADA
## RECENT DEVELOPMENTS

By **Joseph Latham and Brendan O'Neill,** *Goodmans LLP*

**In this year's issue, we provide an in-depth update on a particular area of assets sales that has received considerable judicial attention in Canada over the last year — credit bidding.**

### Introduction

Credit bidding is firmly established in the US and on the rise in Canada.[1] Several factors have contributed to its development. First, it has become increasingly common for CCAA proceedings (and Chapter 11 proceedings) to involve (indeed to basically conclude by way of) a sale of all or substantially all of the debtor's assets. Second, these large-scale asset sales are increasingly being conducted by way of a competitive CCAA auction process at which one or more bids compete for the assets. Third, these CCAA auctions are increasingly being attended by sophisticated loan-to-own investors (acting individually or as a syndicate of lenders) who generally seek to acquire a distressed company and/or its assets by way of either (a) exchanging their debt into equity of the reorganized company in a plan scenario or (b) credit bidding that debt in the event that the restructuring proceeds by way of a sale process. As each of these factors becomes increasingly common and commonplace in Canada, so too does credit bidding.

While there is a considerable body of case law on credit bidding in the US, there is relatively little in Canada. This is because there have been relatively few cases in Canada to date in which secured creditors have sought to use a credit bid to acquire the assets of a debtor in the context of a competitive and/or contested auction process. As a result, there has been little need or reason to date for Canadian courts to consider the validity or value of a credit bid as compared to another more traditional form of non-credit bid. This was, however, precisely the case in the recent cross-border CCAA and Chapter 11 proceedings of White Birch Paper Company. In that case, credit bidding was front and centre in Canada, as the stalking horse bidder, and eventual winning bidder for substantially all of the debtors' assets, acquired those assets in part by way of a significant credit bid launched in the context of a highly competitive and contested CCAA auction process. During the course of the proceedings, the purchaser's credit bid was strongly opposed by other creditors and bidders, and as a result, several elements of credit bidding were extensively considered and discussed by the Quebec Superior Court (Commercial Division) (CCAA Court) and later the Quebec Court of Appeal.[2]

### Background

White Birch Paper Company is part of a large group of companies (collectively,White Birch) involved

in the paper product sector. White Birch owns and operates three pulp and paper mills and a saw mill in Quebec, and a fourth pulp and paper mill in the US through its affiliate, Bear Island Paper Company LLC (Bear Island). Overall, approximately 80 per cent of White Birch's assets and businesses are located in Canada, with the other 20 per cent in the US.

On February 24, 2010, all of the White Birch entities filed in Quebec under the CCAA, and concurrently Bear Island filed Chapter 11 in Virginia under the US *Bankruptcy Code* (collectively, the Debtors). Ernst &Young Inc. was appointed as monitor of the CCAA Debtors (the Monitor). As of the filing date, White Birch owed $428 million in principal and $9.77 million in interest under a First Lien Term Loan (the First Lien Debt), which was secured by the Debtors' fixed assets, and approximately $100 million in principal and $4 million in interest under a Second Lien Term Loan (the Second Lien Debt), among other debt obligations. Shortly after the filing, a $140 million DIP facility, secured by all assets of the Debtors, was approved and provided by a group of lenders drawn from the First Lien Debt syndicate (the DIP).

**The Bidding Procedures and related Orders of the Courts specifically contemplated and permitted credit bidding of amounts due under the DIP or the First Lien Credit Agreement.**

## Process to Auction

As is becoming increasingly common, the DIP contained a series of milestones which called for a parallel process of negotiating a plan of arrangement while concurrently initiating a sale process for all or substantially all of the Debtors' assets in the event that a settlement with creditors pursuant to a plan was not feasible. Eventually, the sale process became the preferred alternative and efforts towards developing a plan of arrangement were discontinued.

The sale process, which contemplated a going-concern sale of both the Debtors' fixed assets (which were collateral for the First Lien Debt) and the Debtors' current assets (which were not), was initiated in mid-April 2010 with the preparation and approval of a "Sale and Investor Solicitation Process" (SISP). The SISP outlined the solicitation process, the conduct of a subsequent auction in the event of competing bids, and the process and requirement for court approval by the CCAA Court and the US Bankruptcy Court.

The sale process under the SISP was managed by Lazard Freres & Co. and, in the end, White Birch received only one formal offer which satisfied all of the SISP requirements. This offer was presented by BD White Birch Investments LLC (BDWBI), an asset acquisition vehicle formed by Black Diamond Capital Management LLC, Credit Suisse Loan Funding LLC, Caspian Advisors LLC, and their respective affiliates (collectively, BDWBI), which held 65.5 per cent of the First Lien Debt and hence constituted "Majority Lenders" under the terms of the First Lien Credit Agreement. Pursuant to the SISP, BDWBI was selected as the "stalking horse" purchaser and negotiated and entered into an asset sale agreement (ASA) with the Debtors. The ASA covered substantially all of the assets of the Debtors, including the Debtors' fixed assets (encumbered by the DIP, the First Lien Debt and the Second Lien Debt) and their current assets (accounts receivable and inventory, which were only encumbered by the DIP). Under the ASA, the cash consideration would pay out the DIP in full. On September 10, 2010, the CCAA Court and the U.S. Bankruptcy Court approved the selection of BDWBI as the proposed stalking horse bidder, the terms of the ASA (subject to certain modifications) and the proposed Bidding Procedures. The Bidding Procedures and related Orders of the Courts specifically contemplated and permitted credit bidding of amounts due under the DIP or the First Lien Credit Agreement.

On the last date for submitting a Qualified Bid pursuant to the Bidding Procedures, the Debtors received a qualifying offer from the newly formed Sixth Avenue Investment Co., LLC (Sixth Avenue), which was funded by a group of other lenders holding approximately 10 per cent of the First Lien Debt (collectively, the Minority Lenders). Pursuant to the Bidding Procedures, Sixth Avenue's bid was recog-

nized by the Debtors and the Monitor as a Qualified Bid and an auction was scheduled.

## Auction

The auction was held on September 21, 2010, at the offices of Kirkland & Ellis LLP in New York. At the end of the auction, BDWBI's final bid was declared to be the Winning Bid and Sixth Avenue's last bid was declared to be the Alternative Bid. The total consideration offered for the Debtors' assets under BDWBI's Winning Bid came to approximately $236.1 million, which was structured as follows:

- a cash amount of $94.5 million, $90 million of which was allocated to the Debtors' unencumbered current assets and $4.5 million of which was allocated to repay the debt related to certain legal hypothecs affecting certain immovable properties in Quebec (which were fixed assets);
- a credit bid of $78 million (of First Lien Debt) allocated to the Debtors' Canadian fixed assets (which were collateral for that debt), which was effectuated by way of the BDWBI group, as Majority Lenders, directing the Agent for the First Lien Debt to make that credit bid on behalf of all the holders of First Lien Debt;
- $36.7 million of assumed liabilities; and
- up to $26.9 million in cure costs.

In the aggregate, under BDWBI's Winning Bid, $126.7 million was allocated to the Debtors' current assets, and $82.5 million was allocated to the Debtors' Canadian fixed assets. Sixth Avenue's final bid, on the other hand, came to approximately $235.6 million (after deducting the $3 million expense reimbursement), resulting in a bid that was $500,000 lower than that of BDWBI. Sixth Avenue's bid included $175 million in cash, $36.7 million in assumed liabilities and up to $26.9 million in cure costs. Under Sixth Avenue's bid, $173.4 million was allocated to the Debtors' current assets and $35.3 million was allocated to the Debtors' fixed assets.

Based on the value attributed to the assets through a combination of cash, assumption of liabilities and credit bids, the Debtors and the Monitor determined that the final offer from BDWBI, which was $500,000 higher than Sixth Avenue's (in accordance with the minimum bid increments under the Bidding Procedures), constituted the highest overall value for the Debtors' assets and the highest recoveries for the Debtors' creditors, in the aggregate and according to their priorities, and the Debtors sought court approval of the sale of their assets to BDWBI pursuant to BDWBI's final bid, with the Monitor's support.

## Objections from the Minority Lenders

At the auction, and at the sale approval hearing, the Minority Lenders raised a number of objections to BDWBI's bid and to any selection of it as the Winning Bid by the Debtors, the Monitor or the Court. The objections made and the responses provided are summarized below.[3]

a. The Agent did not have the right to credit bid because the Minority Lenders had not consented to a credit bid on their behalf – Majority Rules and Drag-Along in Credit Bidding

One of the Minority Lenders' first objections was that Credit Suisse, as the Agent for the First Lien lenders, lacked the authority to make the credit bid that was part of BDWBI's bid because it had not received the consent of the Minority Lenders to make that credit bid on behalf of all the lenders.

BDWBI opposed this argument on the basis that, among other things, under the terms of the First Lien Credit Agreement (i) each lender had irrevocably designated the Agents as the agent for all of the lenders; (ii) each lender had irrevocably authorized the Agents to take such action on its behalf as was permitted under the terms of the First Lien Credit Agreement and the related security documents; and (iii) upon an event of default (as had arisen by virtue of the commencement of the bankruptcy proceedings), the terms of the First Lien Credit Agreement provided that the Agents were authorized and directed to take such actions as shall be reasonably directed by the Majority Lenders. Finally, BDWBI noted that the First Lien Credit Agreement specifically delineated which actions required unanimity of the lenders (such as, for example, to amend the principal amount of the debt), and exercising a right to credit bid was not one of those items.

Accordingly, BDWBI argued that the Majority Lenders were authorized to direct the Agents to credit bid, as they had, that the Agents were in turn authorized to credit bid, and that, by the terms of the First Lien Credit Agreement (to which each lender was a party), all minority lenders were bound to that instruction from the Majority Lenders and would be dragged along with the results of that instruction.

In addition, BDWBI noted that credit bidding was specifically listed as one of the available remedies under the terms of the US security agreements for the First Lien Debt and that, while the Canadian security agreements did not specifically reference the right or ability to credit bid, they stated that the secured parties were authorized – through the Agents upon an event of default – to "exercise any rights, powers or remedies available to Secured Party at law or in equity or under the [PPSA] or other applicable legislation." BDWBI also noted, of course, that credit bidding had already been recognized as an available right under the SISP and the Bidding Procedures and the related Orders of the Courts approving same.

After considering these issues at the sale hearing,

Justice Mongeon found in his Reasons that followed that:

> [17] BDWB is comprised of a group of lenders under the First Lien Credit Agreement and hold, in aggregate approximately 65% of the First Lien Debt. They are also "Majority Lenders" under the First Lien Credit Agreement and, as such, are entitled to make certain decisions with respect to the First Lien Debt including the right to use the security under the First Lien Credit Agreement as [a] tool for credit bidding.
>
> [18] Sixth Avenue is comprised of a group of First Lien Lenders holding a minority position in the First Lien Debt (approximately 10%). They are not "Majority Lenders" and accordingly, they do not benefit from the same advantages as the BDWB group of First Lien Lenders, with respect to the use of the security on the fixed assets of the WB Group, in a credit bidding process.
>
> . . .
>
> [20] In its Intervention, BDWB has analysed all of the rather complex mechanics allowing it to use the system of credit bidding as well as developing reasons why Sixth Avenue could not benefit from the same privilege. In addition to certain arguments developed in the reasons which follow, I also accept as my own BDWB's submissions developed in section (e), paragraphs [40] to [53] of its Intervention as well as the arguments brought forward in paragraphs [54] to [60] validating BDWB's specific right to credit bid in the present circumstances.
>
> [21] Essentially, BDWB establishes its right to credit bid by referring not only to the September 10 Court Order but also by referring to the debt and security documents themselves, namely the First Lien Credit Agreement, the US First Lien Credit Agreement and under the Canadian Security Agreements whereby the "Majority Lender" may direct the "Agents" to support such credit bid in favour of such "Majority Lenders". Conversely, this position is not available to the "Minority Lenders" (Reasons For Judgment Given Orally On September 24, 2010 (Reasons)).

In doing so, Justice Mongeon affirmed that, based on the terms of the First Lien Credit Agreement, the Majority Lenders were authorized to direct the Agents to credit bid and the Minority Lenders were bound to, and would be dragged along with, that instruction.

It is important for practitioners to note that certain elements of this decision were based directly on, and established by, the particular provisions and language of the First Lien Credit Agreement and the related security documents, as referenced above, which highlights the need for a careful review of, and for proper and effective drafting of, the terms of such documents. Justice Mongeon's findings in this regard are consistent with US law in this area. For example, in *In re GWLS Holdings, Inc.*, No. 08-12430, 2009 WL 453110 (Bankr. D. Del. Feb. 23, 2009), Judge Walsh of the Delaware Bankruptcy Court found in the context of a section 363 sale of the debtor's assets that: (i) a majority of lenders could direct the agent to credit bid for all first lien lenders, even absent unanimous consent; (ii) that the minority lenders were bound by that result; (iii) that the agent was able to credit bid the dissenting lender's claim as part of the majority-directed credit bid; and (iv) that the language in the applicable collateral agreement that empowered the agent to "dispose of or deliver the Collateral or any part thereof" was sufficient to allow the agent to credit bid. (For a further discussion of the US law on credit bidding, see BDWBI Intervention at paras. 37-39 and 77-79.)On its later motion for leave to appeal Justice Mongeon's findings in this regard to the Quebec Court of Appeal (which was denied), the Minority Lenders further argued that the BDWBI had breached its fiduciary duties when it chose to credit bid on only the Canadian fixed assets, and not on the US fixed assets (which were also collateral). In doing so, the Minority Lenders claimed that BDWBI had preferred its own interests to those of the First Lien lenders generally and had thereby breached its fiduciary duties to them. In responding to this allegation, Justice Dalphond of the Quebec Court of Appeal concluded that this allegation was an intercreditor matter that would need to be decided by the forum designated under the lenders' credit agreement, and that it was not an issue to be dealt with under the CCAA or by a CCAA court.(Reasons For Judgment Pronounced Orally on October 25, 2010, dated November 1, 2010 ("Reasons of the Court of Appeal"), *White Birch Paper Holding Co., Re,* [2010] 72 C.B.R. (5th) 74 (Qc. C.A.) at paras. 13-20.)

This finding was also consistent with similar decisions from US courts in this area. See, for example, *In re Metaldyne Corp.*, 409 B.R. 671, 679-680 (Bankr. S.D.N.Y.) (finding that disputes over consideration to be received by minority lenders following majority-rule action "raise issues concerning an intercreditor dispute or a dispute between [minority lender] and the Agent, neither of which is properly before this Court at this time, if they ever could properly be brought before this Court.").

b. The Agent lacked authority to credit bid under Quebec law

The Minority Lenders' next objection was that there was no right to credit bid under Quebec law because (i) there is no equivalent to section 363(k) of the US *Bankruptcy Code*[4] in the statutes of Quebec or the federal statutes of Canada and that (ii) under the laws of Quebec (which governed the security over the fixed assets in Quebec), a secured creditor's only options were to sue on the covenant, sell the collateral or take all of the collateral in payment of all of the secured debt – none of which was happening in the White Birch

case. In response, BDWBI noted certain existing (albeit limited) CCAA precedents as a matter of overriding federal CCAA law and that the concept of credit bidding had been accepted under Quebec law generally, drawing a comparison to a hypothecary creditor in Quebec who purchases hypothecated property and is permitted to retain the purchase price to the extent of its secured claim on the property. BDWBI argued that this concept is regularly applied in judicial sales in Quebec and is "the functional equivalent of credit bidding." Moreover, BDWBI cited the provisions of the credit and security documents referenced above and the provisions of the SISP and the Bidding Procedures Orders that had previously recognized the right to credit bid.

In his Reasons, Justice Mongeon acknowledged the existing CCAA precedent[5] and found that the concept of credit bidding was not foreign to Quebec law and procedure, citing several cases and provisions of the Quebec *Code of Civil Procedure* in support of that conclusion. Looking to the words of the Orders that had approved credit bidding at the auction (which said that the lenders under the First Lien Credit Agreement and the DIP would be entitled to credit bid up to the full amount of any allowed secured claims "to the extent permitted under Section 363(k) of the Bankruptcy Code *and other applicable law*"), Justice Mongeon found that: "The words 'and other applicable law' could, in my view, tolerate the inclusion of similar rules and procedures in the province of Quebec" (Reasons, at para. 31). Accordingly, Justice Mongeon found that "those bidders able to benefit from a credit bidding situation could very well revert to the use of this lever or tool to arrive at a better bid" and that there was nothing in federal CCAA law or Quebec provincial law that prevented them from doing so, given the terms of their credit and security documents, as discussed above (Reasons, at paras. 32-33).

c. The value of a credit bid should be limited to the market value of the collateral

The Minority Lenders also argued that, in any event, a dollar of credit bidding should not be considered to be the equivalent of a dollar of cash. Therefore, according to the Minority Lenders, the BDWBI credit bid was not greater than the Sixth Avenue bid and could not be approved as such. Instead, the Minority Lenders argued that a credit bid should be limited to the "market value" of the collateral, and thus BDWBI should not have been permitted to credit bid up to the full face value of the secured debt, but rather only up to the value of the collateral that secured that debt – in which case the BDWBI bid would not have been the winning bid.

In response, BDWBI argued that it was axiomatic that a dollar of credit bid was equal to a dollar of cash, as a credit bid is in essence nothing more than enforcement upon the collateral in respect of which the secured creditor has already paid its $1 – which has already been advanced to the company. Justice Mongeon agreed and affirmed that a dollar of credit bid is equivalent to a dollar of cash bid, and that a credit bid may be made up to the face value amount of the credit instrument upon which the credit bidder is allowed to rely (Reasons, at para. 34.). Justice Mongeon's findings on this point are also consistent with prevailing US law. For example, in *Cohen* v. *KB Mezzanine Fund II LP* (*In re SubMicron Sys. Corp.*), the Third Circuit analyzed whether a secured creditor could credit bid the full face value of its secured debt or whether its credit bid was limited only to the economic value of its collateral. In determining this issue, the Third Circuit held that Section 363(k) of the US *Bankruptcy Code* "empowers creditors to bid the total face value of their claims – it does not limit bids to claims' economic value" (*In re SubMicron*, 432 F.3d 448 at 459 (3rd Cir. 2006)).

d. The Importance and Finality of Process in a CCAA proceeding

In rendering his Reasons for approving the sale to BDWBI, Justice Mongeon also commented extensively on the importance, sanctity and finality of process matters in a CCAA proceeding. These statements are best read in their entirety and, in the authors' view, provide important further support for the sanctity of process doctrine that is central to an efficient and predictable CCAA process and result:

"[37] I have dealt briefly with the process. I don't wish to go through every single step of the process but I reiterate that this process was put in place without any opposition whatsoever. It is not enough to appear before a Court and say: "Well, we've got nothing to say now. We may have something to say later" and then, use this argument to reopen the entire process once the result is known and the result turns out to be not as satisfactory as it may have been expected. In other words, silence sometimes may be equivalent to acquiescence. All stakeholders knew what to expect before walking into the auction room.

[38] Once the process is put into place, once the various stakeholders accept the rules, and once the accepted rules call for the possibility of credit bidding, I do not think that, at the end of the day, the fact that credit bidding was used as a tool, may be raised as an argument to set aside a valid bidding and auction process.

[39] Today, the process is completed and to allow "Sixth Avenue" to come before the Court and say: "My bid is essentially better than the other bid and Court ratify my bid as the highest and best bid as opposed to the winning bid" is the equivalent to a complete eradication of all proceedings and judgments rendered to this date with respect to the

Sale of Assets authorized in this file since May/June 2010 and I am not prepared to accept this as a valid argument. Sixth Avenue should have expected that BDWB would want to revert to credit bidding and should have sought a modification of the bidding procedure in due time.

[40] The parties have agreed to go through the bidding process. Once the bidding process is started, then there is no coming back. Or if there is coming back, it is because the process is vitiated by an illegality or non-compliance of proper procedures and not because a bidder has decided to credit bid in accordance with the bidding procedures previously adopted by the Court.

[41] The Court cannot take position today which would have the effect of annihilating the auction which took place last week. The Court has to take the result of this auction and then apply the necessary test to approve or not to approve that result. But this is not what the contestants before me ask me to do. They are asking me to make them win a bid which they have lost.

[42] It should be remembered that "Sixth Avenue" agreed to continue to bid even after the credit bidding tool was used in the bidding process during the auction. If that process was improper, then "Sixth Avenue" should have withdrawn or should have addressed the Court of directions but nothing of the sort was done. The process was allowed to continue and it appears evident that it is only because of the end result which is not satisfactory that we now have a contestation of the results."

Based on all of the above, Justice Mongeon approved the sale to BDWBI and entered the Approval and Vesting Order dated September 28, 2010 (the Sale Order). As mentioned, the Minority Lenders' application for leave to appeal the Sale Order to the Quebec Court of Appeal was denied.

## Conclusion / Take-Aways

To the authors' knowledge, the White Birch CCAA proceedings came to involve the most significant and extensive discussion and consideration of credit bidding in Canada to date. As such, the case provides several important take-aways concerning the law on credit bidding in Canada, which can be summarized as follows:

- Credit bidding continues to be accepted by Canadian courts.
- The terms of the underlying credit and security documentation are highly relevant to a secured party's right to credit bid, and in particular to a secured party's (or its nominee's or agent's) right to credit bid on behalf of others.
- Secured creditors can credit bid up to the full face value of their secured debt in a sale of their collateral, and that bid will be valued on a dollar-for-dollar basis.
- A credit bid can only be applied to the collateral for that debt. That said, a credit bid can be used as part of an overall bid for encumbered assets and unencumbered assets, provided that an appropriate amount of cash (or some other form of acceptable consideration) is provided for the unencumbered assets.
- In assessing the value of an overall bid, courts will aggregate the value of the credit bid and the value of the cash bid, with each bid being valued on a dollar-for-dollar basis, subject to any specific allocation issues.
- In such circumstances, allocation issues can become very important. In particular, in single sales of mixed assets (that is, where encumbered and unencumbered assets are sold together, such as in a going concern sale perhaps), it will be important for the process to ascribe a minimum cash/consideration requirement for the unencumbered assets (as a credit bid cannot be used for those).
- If participants in an auction have concerns about the ability of a party to credit bid, or the manner in which they may credit bid, it is very important for those parties – be they creditors or other bidders – to raise those concerns early on in the process.
- This case may result in a greater emphasis being placed by Monitors on creating clear rules for credit bidding in advance of an auction, and Monitors may increasingly seek to have those rules blessed by the CCAA court in advance.
- The CCAA Court recognized that "bitter bidders" may have standing after a sale process to argue that there has been non-compliance with the Court-approved process. Beyond that, Canadian courts remain generally unsympathetic to "bitter bidders" and continue to place considerable emphasis on the sanctity and finality of a Court-approved process.
- CCAA courts may refuse to consider certain arguments regarding credit bidding to the extent that they constitute inter-lender disputes which should be determined according to the dispute resolution provisions (or governing law and forum provisions) of the credit or security agreement in place among the lenders.

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**1 "Credit bidding" occurs when a secured creditor (or its nominee) bids the secured debt it holds to acquire its collateral in a sale of that collateral. Credit bidding allows a secured creditor to use its debt as currency in a sale of the collateral recognizing that the proceeds of that sale would go to the secured creditor (as the priority creditor) in any event. A credit bid can only be used to acquire property that is collateral for that debt. If other unencumbered assets are to be acquired as part of the purchase, cash (or some other form of acceptable consideration) must be paid by the**

**creditor/purchaser for the other unencumbered assets. The right of a secured creditor to credit bid is expressly provided for in the U.S.** *Bankruptcy Code* **under section 363(k); it is not referenced in either the** *Canadian Bankruptcy and Insolvency Act* **(BIA) or the CCAA.**

**2 The authors are Brendan O'Neill and Joe Latham of Goodmans LLP in Toronto (Goodmans). Together, Goodmans, Lavery de Billy LLP in Montréal (Jean-Yves Simard and Jonathan Warin) and Skadden, Arps, Slate, Meagher & Flom LLP in the U.S. (Kimberly DeBeers, Chris Dickerson and Matt Murphy) represented Black Diamond and a group of investors in their successful acquisition of the assets of the debtors through an auction-based credit bid in the Quebec-based White Birch CCAA proceedings. The authors would like to thank Caroline Descours of Goodmans for her contribution in preparing this article.**

**3 For a more thorough discussion of the objections made by the Minority Lenders and the responses of BDWBI, the Debtors, the Monitor and the Courts thereto, see the record of the White Birch CCAA proceedings available at the Monitor's website for the proceedings: http://documentcentre.eycan.com/. In particular, see the Contestation Of The Debtors' Motion To Approve The Sale Of Substantially All Of The WB Group's Assets And Cross-Demand By The Intervening Parties dated September 23, 2010, and the Intervention And Memorandum Of Arguments Of BD White Birch Investment LLC dated September 23, 2010 (the BDWBI Intervention).**

**4 Section 363(k) of the US Bankruptcy Code states that: "(k) At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of the property." 11 U.S.C. §§ 101 et seq.**

**5 Reasons, at footnote 4: "As for the right to credit bid in a sale by auction under the CCAA, see Re: Maax Corporation (QSC. No. 500-11-033561-081, July 10, 2008, Buffoni J.). See also Re: Brainhunter (OSC Commercial List, no. 09-8482-00CL, January 22, 2010)."**

Partner with Goodmans' Corporate Restructuring Group, focusing on commercial insolvencies, including bankruptcies, receiverships and restructurings, and having advised debtors, secured/unsecured creditors, receivers, trustees and monitors. He has been involved in numerous Canadian and cross-border proceedings, including White Birch Paper, Chemtura, Eddie Bauer, InterTAN (Circuit City), Cow Harbour, Waterford-Wedgwood/Royal Doulton, Coppley Apparel, Accuride, A&M Cookie, Colonial Cookies, SKD Automotive, One King West, Hamilton Specialty Bar, Philip Services (2003), Consumers Packaging, A.G. Simpson and TCT Logistics.

**L. Joseph Latham**
*Goodmans LLP*

Tel: (416) 597-4211
Fax: (416) 979-1234
jlatham@goodmans.ca

Partner with Goodmans' Corporate Restructuring Group with significant experience in out-of-court restructurings, cross-border and transnational insolvencies and restructurings, US Chapter 11 reorganizations, Canadian CCAA/CBCA restructurings, bankruptcy-based acquisitions and near-insolvency investing scenarios. O'Neill has represented debtors, secured/unsecured creditors, official/unofficial committees, bondholders, shareholders and investors focused on distressed situations. He has been involved in the restructurings of Calpine Canada, ABCP, Pliant, Lear, Mecachrome, SemCanada, Allen-Vanguard, Frontera Copper, Compton Petroleum, White Birch Paper and TerreStar Networks, among many others.

**Brendan O'Neill**
*Goodmans LLP*

Tel: (416) 849-6017
Fax: (416) 979-1234
boneill@goodmans.ca

# TAB 18

**In re: THE FREE LANCE-STAR PUBLISHING CO. OF FREDERICKSBURG, VA, et al., Debtors.**

**Case No. 14-30315-KRH, Chapter 11 (Jointly Administered)**

**UNITED STATES BANKRUPTCY COURT FOR THE EASTERN DISTRICT OF VIRGINIA, RICHMOND DIVISION**

**512 B.R. 798; 2014 Bankr. LEXIS 1611**

**April 14, 2014, Decided**
**April 14, 2014, Entered on Docket**

**COUNSEL:** **[**1]** For The Free Lance-Star Publishing Co. of Fredericksburg, Va., dba The Free Lance-Star Publishing Co., dba The Free Lance-Star, dba JobFetch, dba fredericksburg.com, dba Print Innovators, dba Star Radio Group, Debtor: Paula S. Beran, Lynn L. Tavenner, Tavenner & Beran, PLC, Richmond, VA.

For U.S. Trustee: Judy A. Robbins, Office of the U.S. Trustee - Region 4 -R, Richmond, VA.

For Official Committee of Unsecured Creditors of the Free Lance-Star Publishing Co. of Fredericksburg, VA., et al., Creditor Committee: Tyler P. Brown, Shannon Eileen Daily, Jason William Harbour, Justin F. Paget, Hunton & Williams LLP, Richmond, VA.

**JUDGES:** Kevin R. Huennekens, UNITED STATES BANKRUPTCY JUDGE.

**OPINION BY:** Kevin R. Huennekens

**OPINION**

**[*799]** <u>MEMORANDUM OPINION</u>

On January 23, 2014 (the "Petition Date"), The Free Lance-Star Publishing Company of Fredericksburg, VA ("The Free Lance-Star") and William Douglas Properties, LLC ("William Douglas" and, together with The Free Lance-Star, the "Debtors") filed voluntary petitions for relief under Chapter 11 of Title 11 of the United States Code. 11 U.S.C. §101 *et. seq.* (the "Bankruptcy Code"). The Debtors' bankruptcy cases are being jointly administered pursuant to the Court's Order of January 30, **[**2]** 2014. The Debtors are continuing to operate their business as Debtors-in-Possession ("DIP") under §§ 1107 and 1108 of the Bankruptcy Code.

The Debtors filed on the Petition Date a Motion to Sell Business Assets and a Motion **[*800]** to Sell Tower Assets [1] (collectively, the "Sale Motions") seeking approval of bidding procedures for an auction of substantially all of the Debtors' assets. On March 10, 2014, the Court entered orders approving the bidding procedures set out in each of the Sale Motions, including the right of DSP Acquisition, LLC ("DSP") to credit bid its claim against the Debtors' assets on which it had valid liens or security interests, as either (i) agreed to by the Debtors, DSP, and the Official Committee of Unsecured Creditors (the "Committee") or (ii) as determined by the Court at a hearing to be held on March 24, 2014.

1 The Debtors own and operate four radio stations in addition to its printing and newspaper businesses. The Tower Assets are employed in broadcasting activities associated with the

> Debtors' operation of its radio business. The Tower Assets include the Tower Parcels and the improvements thereon; certain equipment located on the Tower Parcels; all permits issued **[**3]** to the Debtors relating to the ownership or operation of the foregoing assets; all contracts related to the Tower Assets that are designated to be assumed; any counterclaims, setoffs, or defenses that the Debtors may have with respect to any assumed liabilities designated by the purchaser of the Tower Assets; all of the Debtors' insurance policies insuring the Tower Real Property or the other Tower Purchased Assets, to the extent assignable; all of the Debtors' indemnification rights under or with respect to the Assumed Liabilities or other Tower Purchased Assets; and certain documents relating to the Tower Assets or to the Assumed Liabilities. The Sale Motions included a procedure for a separate sale of the Debtors' Tower Assets, as the Debtors assert that no entity has a lien on or security interest in the Tower Assets.

Also on March 10, 2014, DSP filed a Complaint (the "Complaint") initiating Adversary Proceeding No. 14-03038 (the "Adversary Proceeding"). The Complaint seeks a declaration that DSP has valid and perfected liens on substantially all of the Debtors' assets including the Tower Assets. DSP has also filed a motion seeking summary judgment pursuant to Rule 56(c) of the Federal Rules of Civil Procedure, **[**4]** as incorporated by Rule 7056 of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules") on all counts set forth in its Complaint (the "Plaintiff's Motion for Summary Judgment"). DSP filed the Declaration of Allyson Brunetti in support of the Complaint and Plaintiff's Motion for Summary Judgment.[2] The Debtors, who are the named defendants in the Complaint, filed their own motion for summary judgment against DSP (the "Defendants' Motion for Summary Judgment" and together with Plaintiff's Motion for Summary Judgment, the "Cross Motions for Summary Judgment").

2 An affidavit or declaration used to support or oppose a motion must be made on personal knowledge, set out facts that would be admissible in evidence, and show that the affiant or declarant is competent to testify on the matters stated. Fed. R. Civ. P. 56(c)(4).

On March 24, 25, and 31, 2014, the Court conducted an evidentiary hearing (the "Hearing") (i) to determine DSP's right to credit bid its claim against the Debtors' assets in connection with the Sale Motions and (ii) to determine the validity, extent and priority of the liens asserted by DSP in connection with the Cross Motions for Summary Judgment. At the conclusion **[**5]** of the Hearing, the Court ruled that DSP did not have valid, properly perfected liens on the Tower Parcels or the improvements thereon, the other Tower Assets, the FCC licenses, the rolling stock, insurance policies, and/or bank accounts. The Court also ruled that 11 U.S.C. § 552 prevented DSP from asserting a lien on any proceeds that may be derived from the disposition of any of the forgoing assets on which it did not have a valid lien as of the Petition Date. Accordingly, the Court denied Plaintiff's Motion for Summary Judgment and granted partial summary judgment in **[*801]** favor of the Debtors on Defendants' Motion for Summary Judgment.[3] The Court ruled that DSP could not credit bid a claim against assets on which it lacked a valid lien or security interest. The Court found that DSP had engaged in inequitable conduct that, under the circumstances, required the Court to limit DSP's credit bid right in order to foster a robust auction. This Memorandum Opinion sets forth the Court's findings of fact and conclusions of law pursuant to Bankruptcy Rule 7052.[4]

3 *See* Order and Memorandum Opinion of even date in Adversary Proceeding.

4 Findings of fact shall be construed as conclusions of law and **[**6]** conclusions of law shall be construed as findings of fact when appropriate. See Fed. R. Bankr. P. 7052.

The Court has subject-matter jurisdiction over the Sale Motions and the Adversary Proceeding pursuant to 28 U.S.C. §§ 157 and 1334 and the general order of reference from the United States District Court for the Eastern District of Virginia dated August 15, 1984. This is a core proceeding under 28 U.S.C. § 157(b)(2)(A), (C), (K), (N) and (O). Venue is appropriate pursuant to 28 U.S.C. § 1409.

Section 363(b)(1) of the Bankruptcy Code provides that a trustee, "after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate." 11 U.S.C. § 363(b)(1). DSP argues that, as the holder of a secured claim, the Bankruptcy Code gives it the right to credit bid its claim

at such a sale. *See* 11 U.S.C. § 363(k). The Debtors submit that "cause" exists in this case to limit the credit bid amount. *See id.* DSP, as the entity asserting an interest in property of the estate, has the burden of proof on the issue of the validity, priority, or extent of its liens. 11 U.S.C. § 363(p)(2). Because it is the filing of the objection that creates a contested **[**7]** matter under Rule 9014 of the Bankruptcy Rules, the Debtors, as the objecting parties, are treated as the movants and have the burden of proving cause under § 363(k) of the Bankruptcy Code. *See In re DeSoto,* 33 C.B.C.2d 902, 905, 181 B.R. 704, 706 (Bankr. D. Conn. 1995).

As a general rule, a "preponderance of the evidence" standard is appropriate in all bankruptcy proceedings. *Grogan v. Garner,* 498 U.S. 279, 286, 111 S.Ct. 654, 112 L.Ed.2d. 755 (1991); *see, e.g., In re Santaella*, 298 B.R. 793, 799 (Bankr. S.D. Fla. 2002); *see also In re Galanis,* 334 B.R. 685 (Bankr. D. Utah 2005). "Preponderance of the evidence" is the weight accorded to the aggregate evidence on either side. It is synonymous with the term "greater weight of the credible evidence." 30 Am. Jur. 2d Evidence § 1164, at 339 (1967). The Court will apply the "preponderance of the evidence" standard to the issues at bar.

**Facts**

The Free Lance-Star is a family-owned publishing, newspaper, radio, and communications company located in Fredericksburg, Virginia (the "Company"). William Douglas is a related entity that owns a portion of the land on which The Free Lance-Star operates its business. The Free Lance-Star owns the Tower **[**8]** Assets, which include three parcels of real estate (the "Tower Parcels"). The Tower Assets are the primary focus of the Sale Motions and the Cross Motions for Summary Judgment. The Tower Assets are used predominately in The Free Lance-Star's radio broadcasting operations. The first of the Tower Parcels is located at 122 Mountain Avenue in Stafford County, Virginia. The second of the Tower Parcels is located at **[*802]** 6701 Rumsey Lane in Spotsylvania County, Virginia. The third of the Tower Parcels is located at 22601 Penola Road in Caroline County, Virginia. Between 1988 and 1998, The Free Lance-Star improved the Stafford County Tower Parcel by constructing a guy wired mast on the property. Towers were already erected on the Spotsylvania County and Caroline County Tower Parcels when the Debtors purchased those properties (collectively, the masts erected on the Tower Parcels, the "Towers").

In 2006, the Debtors developed a plan to expand their commercial printing business. To undertake this expansion, the Debtors borrowed funds from Branch Banking and Trust ("BB&T") in the approximate amount of $50.8 million (the "Loan"). To secure this Loan the Debtors granted liens on, and security interests **[**9]** in, certain of the Debtors' real and personal property. The Debtors did not agree to grant any liens on or security interests in the Tower Assets, nor did BB&T record deeds of trust covering the Tower Parcels. BB&T did not obtain or record any assignment of leases or rents concerning the Tower Parcels. The Credit Agreement makes no reference to granting liens on the Tower Assets, nor does the Security Agreement specifically reference the Tower Assets. It appears that during the time that BB&T held the Loan, BB&T did not record any financing statements perfecting a security interest in any of the Tower Assets.

With the Loan, the Debtors built a state-of-the-art printing facility that began operation in 2009. Construction of the facility coincided with the severe recession that began in December 2007 and ended in June 2009. In early 2009 the Company fell out of compliance with certain of the Loan covenants contained in its Loan agreement with BB&T. In December of 2011, the Company signed a forbearance agreement with BB&T. The Company continued to make timely payments to BB&T even as its revenue declined. Prevailing economic conditions prevented the Company from restructuring its business **[**10]** and becoming compliant with its Loan covenants. The Company was unsuccessful in its attempts to obtain replacement refinancing. Finally, in late June of 2013, BB&T sold its Loan to Sandton Capital Partners ("Sandton").[5]

5 Counsel for DSP suggested at the Hearing that DSP is an affiliated entity operated by Sandton Capital Partners and that DSP is now the holder of the Draw Commercial Note dated September 11, 2007, made by the Debtors payable to the order of BB&T in the original principal amount of $45,842,400.00.

On July 3, 2013, Sandton informed the Debtors that it wanted the Company to file a Chapter 11 bankruptcy case and sell substantially all of the Debtors' assets pursuant to 11 U.S.C. § 363. Sandton indicated that it intended to be the entity that purchased the Debtors' assets at the bankruptcy sale. Sandton advised that it

would continue to operate the business and that it intended to keep the Debtors' management in place. Thereafter, the Debtors agreed to work on implementing a plan that would involve the Debtors filing a Chapter 11 bankruptcy case and selling all of their assets to DSP pursuant to 11 U.S.C. § 363, so long as it was done in the best interests of the estate, and **[**11]** was within the fiduciary duties of the Debtors' officers and directors.

On or about July 25, 2013, the Debtors received, on behalf of DSP, a request that the Debtors execute three deeds of trust to encumber the Tower Parcels.[6] On or **[*803]** about August 8, 2013, counsel for DSP provided a "Restructuring Timetable" that contained an expectation for the timely recordation of the executed deeds of trust and the commencement of the bankruptcy case in September of 2013. Over the next several days, email correspondence concerning the "Restructuring Timetable" was exchanged between counsel for the Debtors and DSP. Communication between the parties stopped abruptly in mid-August. Unbeknownst to the Debtors, during the several weeks of ensuing silence, DSP unilaterally filed UCC Fixture Financing Statements in Caroline County, Stafford County, and Spotsylvania County. DSP was the first entity since the Loan's inception to attempt to perfect a security interest in the Debtors' Tower Assets.[7]

6 These Deeds of Trust sought to expand the scope of the initial Security Agreement entered into between BB&T and the Debtors by granting consensual liens on the Debtors' Tower Parcels and the improvement thereon.

7 The **[**12]** financing statements purported to perfect a security interest in, among other things, "all machinery, equipment, fixtures, and other property of every kind and nature whatsoever owned by the Debtor . . . located upon the [Tower Parcels]."

On September 24, 2013, DSP resumed negotiations by providing the Debtors with a revised Forbearance Agreement that did not require that the Debtors execute the deeds of trust. The revised Forbearance Agreement included instead a provision for a blanket release of all claims held by the Debtors against DSP. The Debtors' attempts to limit the blanket release provision to apply only to all known claims were soundly rejected by DSP. DSP explained that the new Forbearance Agreement did not include the additional mortgages and liens on the Tower Assets as DSP expected to pick up that collateral in a DIP post-petition financing order.

Ninety days after DSP had recorded its UCC Fixture Filings, DSP renewed its pressure on the Company for a speedy bankruptcy filing. The Debtors requested a meeting with DSP and its counsel at which a coordinated, global, planned approach for a bankruptcy case could be developed. On December 3, 2013, the Debtors held a phone conference **[**13]** with representatives of DSP. During this meeting, DSP indicated, among other things, that there was no reason to market the Debtors' assets. DSP insisted that the timeframe for conducting a bankruptcy sale of its business, with a credit bid, should be no more than six weeks from petition date to closing. DSP strongly objected to the Debtors' engagement of Protiviti as the Debtors' financial consultant. When Protiviti insisted upon distributing marketing materials in connection with the bankruptcy sales process, DSP required that the marketing materials contain on the front page, in bold font, a statement that DSP had a right to a $39 million credit bid.

The Debtors continued to express a willingness, consistent with their fiduciary responsibilities, to work with their secured lender in order to develop a fair process to market the Company's assets in a manner designed to maximize value for the benefit of the estate as a whole. When Protiviti developed cash flow projections for the Company, which cash flow projections indicated that the Company could survive in bankruptcy without a post-petition DIP loan facility, the relationship between the Debtors and the secured lender turned sour. **[**14]** Counsel for DSP challenged Protiviti's projections as too optimistic. DSP insisted that the Company had to have a new post-petition loan facility made by DSP. Otherwise, DSP would not be able to get the liens it coveted on the Tower Assets. The Debtors refused the new loan and all negotiations between the Debtors and DSP ceased at that point.

**[*804]** On January 11, 2014, DSP contacted counsel for the Debtors and informed them that DSP no longer supported a bankruptcy filing under the terms proposed by the Debtors. DSP advised that it would be suspending all work in connection with the bankruptcy filing. The next week, DSP recorded additional financing statements in various jurisdictions without giving any notice to the Debtors. The Debtors commenced the bankruptcy case without the support of their secured

lender.

Following the Petition Date, DSP objected to the Debtors' use of cash collateral. At a contested hearing conducted on January 24, 2014, DSP asked the Court to give DSP new liens on the Tower Assets as additional adequate protection to supplement the post-petition replacement liens and adequate protection payments offered by the Debtors. DSP did not disclose to the Court or the Debtors **[**15]** that it had already recorded financing statements against the Tower Assets in August of 2013 and again in January of 2014. The Court denied DSP's request for the supplemental liens, finding that DSP's interest in cash collateral was adequately protected.

DSP failed to provide any witness at the Hearing to refute the Debtors' allegations that DSP's conduct was inequitable. DSP provided no evidence concerning its acquisition of the BB&T loan. In fact, there is no evidence that DSP is the holder of the Draw Commercial Note dated September 11, 2007, made by the Debtors payable to the order of BB&T in the original principal amount of $45,842,400 (the "Note"). The Court invited DSP to supplement the record with this information and with information about the amount paid for the Loan, but DSP made the calculated decision not to do so. The only witness DSP did provide at the Hearing was found to be not credible. The declaration filed by DSP in support of its Complaint was found to be both false and misleading.[8]

> 8 *See* Order and Memorandum Opinion on Emergency Motion for Reconsideration entered in Adversary Proceeding No. 14-03038.

**Analysis**

A secured creditor should be entitled to credit bid the **[**16]** full amount of its claim at any sale of its collateral outside the ordinary course of the debtor's business. *In re SubMicron Sys. Corp.*, 432 F.3d 448, 459-60 (3d Cir. 2006) (collecting cases and holding that the district court did not err in allowing secured creditors to credit bid the full face value of their claims when the plan administrator sought to limit the secured creditors' credit bids to the economic value of their claims). *See also Suncruz Casinos*, 298 B.R. 833, 838-39 (S.D. Fla. 2003) (stating that a secured creditor may credit bid the full amount of its claim, including any deficiency claim). The right to credit bid is codified in § 363(k) of the Bankruptcy Code which provides:

> At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise, the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.

11 U.S.C. § 363(k).

The right to credit bid under § 363(k) of the Bankruptcy Code is an important safeguard that insures against the undervaluation of the secured **[**17]** claim at an asset sale.[9] Credit bidding "allows the **[*805]** secured creditor to bid for its collateral using the debt it is owed to offset the purchase price[,]" which "ensures that, if the bidding at the sale is less than the amount of the claim the collateral secures, the secured creditor can, if it chooses, bid up the price to as high as the amount of its claim." *Quality Props. Asset Mgmt. Co. v. Trump Va. Acquisitions, LLC,* No. 3:11-CV-00053, 2012 U.S. Dist. LEXIS 115225, 2012 WL 3542527, at *7 n.13 (W.D.V.A. Aug. 16, 2012); *RadLax Gateway Hotel, LLC v. Amalgamated Bank*, 132 S.Ct. 2065, 2070 n.2, 182 L. Ed. 2d 967 (2012) ("The ability to credit-bid helps to protect a creditor against the risk that its collateral will be sold at a depressed price [ ]" by enabling the secured "creditor to purchase the collateral for what it considers the fair market price (up to the amount of its security interest) without committing additional cash to protect the loan.").

> 9 Section 506(a) of the Bankruptcy Code limits a creditor's allowed secured claim to the value of the collateral.

Credit bidding, however, is not an absolute right. *See In re Antaeus Tech. Servs., Inc.*, 345 B.R. 556, 565 (Bankr. W.D. Va. 2005). The Bankruptcy Court in Delaware recently **[**18]** admonished that while "[i]t is beyond peradventure that a secured creditor is entitled to credit bid its allowed claim . . . [t]he law is equally clear, as § 363(k) provides, that the Court may 'for cause order otherwise.'" 11 U.S.C. §363(k). *See, e.g., In re Fisker Auto. Holdings, Inc.,* Case No. 13-13087-KG, 510 B.R. 55, 2014 Bankr. LEXIS 230 at *15-17 (Bankr. D. Del. Jan. 17, 2014); *see also In re Philadelphia Newspapers,*

*LLC,* 599 F.3d 298, 315-316 (3d Cir. 2010). Generally, "a court may deny a lender the right to credit bid in the interest of any policy advanced by the Code, such as to ensure the success of the reorganization or to foster a competitive bidding environment." *Philadelphia Newspapers,* 599 F.3d, at 316, n. 14. *See also In re Aloha Airlines Inc.,* No. 08-00337, 2009 Bankr. LEXIS 4588, 2009 WL 1371950, at *8 (Bankr. D. Hawaii May 14, 2009); *Greenblatt v. Steinberg,* 339 B.R. 458, 463 (N.D. Ill. 2006); *In re Theroux*, 169 B.R. 498, 499 n. 3 (Bankr. D.R.I. 1994) ("[T]here is no absolute entitlement to credit bid.").

The court in *In re Antaeus Tech. Servs., Inc.* denied the right of a secured creditor to credit bid in order to facilitate a fully competitive auction. *In re Antaeus,* 345 B.R. at 565. **[**19]** The court in *In re Fisker* found "cause" existed under § 363(k) of the Bankruptcy Code where the secured lender had chilled the bidding process by inequitably pushing the debtor into bankruptcy so that it could short-circuit the bankruptcy process. *In re Fisker*, 2014 Bankr. LEXIS 230 at *15-17.

The Debtors in the case at bar urge the Court to find cause exists to limit DSP's credit bid rights. The Debtors advance three reasons for doing so. First, DSP does not have a lien on all of the Company's assets. The Debtors argue that it is axiomatic that a creditor cannot credit bid the economic value of its claim against assets in which it holds no security interest. Second, the Debtors maintain that DSP has engaged in inequitable conduct that has damped interest in the auction and depressed the potential sales price the Debtors' otherwise might have realized from the sale of the the business. Finally, limiting the amount of the credit bid in this case will restore enthusiasm for the sale and foster a robust bidding process. Maximizing the value debtors might be able to realize from the sale of their assets is an important policy advanced by the Bankruptcy Code.

The Court has addressed separately the validity and **[**20]** extent of DSP's liens. The Court has held that DSP does not have a valid perfected security interest in all of the assets upon which it asserts it does. DSP does not have valid, properly perfected liens on, or security interests in, **[*806]** the Debtors' Tower Assets, the Debtors' motor vehicles, the Debtors' FCC licenses, the Debtors' insurance policies, or the Debtors' bank account deposits. DSP's lien on general intangibles does not give it a lien on the proceeds the Debtors will generate from the bankruptcy sale. The Court has denied Plaintiff's Motion for Summary Judgment and has granted partial judgment on Defendants' Motion for Summary Judgment.[10] DSP does not have a right to assert a credit bid on assets that do not secure DSP's allowed claim.

10 *See* Order and Memorandum Opinion of even date in Adversary Proceeding No. 14-03038.

From the moment it bought the loan from BB&T, DSP pressed the Debtor "to walk hand in hand" with it through an expedited bankruptcy sales process. It was a classic loan-to-own scenario. DSP made no secret of the fact that it acquired the Loan in order to purchase the Company. It planned from the beginning to effect a quick sale under § 363 of the Bankruptcy Code **[**21]** at which it would be the successful bidder for all the Debtors' assets utilizing a credit bid.

The bump in the road occurred in July of 2013, when DSP learned that it did not have a lien on the Debtors' Tower Assets. DSP made the unilateral decision to expand the scope of its security interest when DSP's overt requests for the Debtors to grant such liens on the Tower Assets failed. DSP's protestations to the contrary notwithstanding, DSP knew it did not have a valid lien on the Tower Assets when it filed the Financing Statements. The Court is troubled by DSP's recordation of the UCC Fixture Financing Statements in Stafford County, Spotsylvania County, and Caroline County in August of 2013 and again in January of 2014. The Court is disappointed that DSP neglected to disclose the Fixture Filings at the January 24, 2014, contested cash collateral hearing during which DSP requested the Court to grant it liens on those very assets.[11] DSP pressured the Debtors to shorten the Debtors' marketing period for the sale of its business and to put language in the marketing materials conspicuously advertising DSP's credit bid rights. The Court is equally troubled by DSP's efforts to frustrate the **[**22]** competitive bidding process.

11 The Court is quite concerned by the false declaration DSP filed in support of Plaintiff's Motion for Summary Judgment in the Adversary Proceeding.

The Court finds that DSP did engage in inequitable conduct. The credit bid mechanism that normally works to protect secured lenders against the undervaluation of collateral sold at a bankruptcy sale [12] does not always function properly when a party has bought the secured

debt in a loan-to-own strategy in order to acquire the target company. In such a situation, the secured party may attempt to depress rather than to enhance market value. Credit bidding can be employed to chill bidding prior to or during an auction, or to keep prospective bidders from participating in the sales process. DSP's motivation to own the Debtors' business rather than to have the Loan repaid has interfered with the sales process. DSP has tried to depress the sales price of the Debtors' assets, not to maximize the value of those assets. A depressed value would benefit only DSP, and it would do so at the expense of the estate's other creditors. The deployment of DSP's loan-to-own strategy has depressed enthusiasm for the bankruptcy sale **[**23]** in the marketplace.

12 *See In re Philadelphia Newspapers, LLC,* 599 F.3d 298, 315-316 (3rd Cir. 2010).

**[*807]** The only testimony provided at the Hearing regarding the proposed bidding procedures and auction process was from the Debtors' expert witness, Suzanne Roski ("Roski") from the firm of Protiviti, Inc ("Protiviti").[13] Roski presented evidence at the Hearing that many interested parties have executed nondisclosure agreements. Many of those same parties have visited the data room, which is populated with confidential financial information concerning the Debtors' business, in order to conduct preliminary inquiry in connection with the sale. To date, however, only one party has made a site visit. Numerous parties are awaiting resolution of the credit bid issue before launching advanced due diligence. There is genuine confusion among potentially interested parties over on what assets DSP has a lien and on how the auction process may unfold.

13 Protiviti is serving as Debtors' financial advisors in this bankruptcy case pursuant to order of this Court. Counsel for DSP acknowledged during the course of the Hearing that Protiviti is among the best firms in the restructuring world.

Potential bidders **[**24]** are now less likely to participate in the sale process. Roski testified that under the unique circumstances of this case, limiting DSP's credit bid would help restore a competitive bidding environment and engender enthusiasm for the sale. DSP chose not to present any evidence to refute or otherwise contradict this testimony. The Court can only conclude from the uncontroverted evidence presented that it is necessary to limit DSP from bidding the full amount of its claim against all of the Debtors' assets in order to foster a fair and robust sale.

At the Court's request, Roski testified as to the best procedure for fashioning a competitive auction sale and credit bid price. The Court had concerns about the sensitive nature of this testimony and about the potential for disclosure of confidential business information that might compromise the competitive nature of the auction. Accordingly, the Court ordered the courtroom to be closed to the public for this portion of Roski's testimony. The Court also ordered the transcript of the closed proceeding to be placed under seal.

The methodology Roski employed eliminated the unencumbered assets of the Debtors from the potential credit bid and applied **[**25]** a market analysis to develop an appropriate cap for a credit bid that would foster a competitive auction process. Roski cautioned that the methodology was not intended to present a valuation of the Company or any of its specific assets. The Court is satisfied that Roski's approach was appropriate and that her conclusions were based upon credible analysis. Given the Court's finding that cause exists under the facts and circumstances presented in this case to limit the amount of DSP's credit bid, Roski's recommendations properly address the Court's concern for fostering a competitive sale while maintaining a fair credit bid amount. DSP failed to provide the Court with any alternative method for limiting the credit bid, and it declined the Courts invitation to provide evidence of the amount it paid for the Loan.

**Conclusion**

The confluence of (i) DSP's less than fully-secured lien status; (ii) DSP's overly zealous loan-to-own strategy; and (iii) the negative impact DSP's misconduct has had on the auction process has created the perfect storm, requiring curtailment of DSP's credit bid rights. First, the Debtors' business operation necessarily includes unencumbered assets upon which DSP has **[**26]** no lien. The credit bid amount must be configured to prevent DSP from credit bidding its claim against assets such **[*808]** as the FCC licenses that are not within the scope of its collateral pool. Second, DSP's loan-to-own strategy has depressed enthusiasm for the sale in the marketplace. Potential bidders now perceive the sale of the business to DSP as a *fait accompli.* Those parties are not inclined to participate in an auction process. Third, limiting DSP's credit bid will attract renewed interest in the bidding

process and will serve to increase the value realized for the assets.

Although DSP has engaged in inequitable conduct, the Court will not extinguish DSP's right to credit bid entirely. But sufficient cause exists for the Court to limit that credit bid amount in order to foster a robust and competitive bidding environment. Accordingly, the Court will sustain the Debtors' objection. DSP's right to credit bid under § 363(k) of the Bankruptcy Code will be limited to $1,200,000 for assets related to the Debtors' radio business on which DSP has a valid, properly perfected lien and $12,700,000 for assets related to the Debtors' newspaper and printing business on which DSP has a valid, properly **[**27]** perfected lien.[14]

14 For purposes of this decision, the Court has presumed that DSP is the holder of the Note. In order to take advantage of any credit bid, DSP must first provide proof that the Debtors and the Committee agree is sufficient, or if there is a disagreement as to the sufficiency of the proof, proof the Court concludes is sufficient, that it is indeed the lender who holds the Note that gives rise to a credit bid pursuant to 11 U.S.C. § 363(k).

A separate order shall issue.

ENTERED: April 14, 2014

/s/ Kevin R. Huennekens

UNITED STATES BANKRUPTCY JUDGE

ENTERED ON DOCKET

April 14, 2014

**ORDER**

This matter comes before the Court on (i) the *Motion of the Debtors for (I) an Order (A) Approving Bidding Procedures, (B) Scheduling Bid Deadline, Auction Date, and Sale Hearing and Approving Form and Manner of Notice Thereof; and (C) Approving Cure Procedures and the Form and Manner of Notice Thereof; and (II) an Order Approving the Sale of Certain of the Debtors' Assets Free and Clear of Liens, Claims and Interests* [Docket No. 17] (the "Newspaper and Printing Business Sale Motion"); (ii) the *Motion of the Debtors for (I) an Order (A) Approving Bidding Procedures, (B) Scheduling Bid Deadline, Auction Date, and Sale* **[**28]** *Hearing and Approving Form and Manner of Notice Thereof; and (C) Approving Cure Procedures and the Form and Manner Of Notice Thereof; and (II) an Order Approving the Sale of Tower Assets of the Debtors Free and Clear of Liens, Claims and Interests* [Docket No. 18] (the "Radio Business Sale Motion"; and together with the Newspaper and Printing Business Sale Motion, the "Sale Motions"); (iii) the *Order Pursuant to 11 U.S.C. §§ 105, 363 and 365 and Rules 2002, 6004, 6006 and 9014 of the Federal Rules of Bankruptcy Procedure (I) Approving Bidding Procedures; (II) Scheduling Bid Deadline, Auction Date and Sale Hearing and Approving Form and Manner of Notice Thereof; and (III) Granting Related Relief* [Docket No. 112] (the "Newspaper and Printing Business Sale Procedures Order"); (iv) the *Order Pursuant to 11 U.S.C. §§ 105, 363 and 365 and Rules 2002, 6004, 6006 and 9014 of the Federal Rules of Bankruptcy Procedure (I) Approving Bidding Procedures; (II) Scheduling Bid Deadline, Auction Date and Sale Hearing and Approving Form and Manner of Notice Thereof; and (III) Granting Related Relief* [Docket No. 111] (the "Radio Business Sale Procedures Order;" and together with the Newspaper and Printing Business Sale Procedures Order, the "Sale Procedures Orders").

An evidentiary hearing was conducted on March 24, 25, and 31, 2014 (the "Hearing"), to determine the right of DSP **[**29]** Acquisition, LLC ("DSP") to credit bid its claim against the Debtors' assets on which it had valid liens or security interests. Upon consideration of the record, the pleadings, the admitted evidence, and arguments of counsel based on admitted evidence, and for the reasons set forth on the record from the bench on March 25, 2014 and March 31, 2014, and in the Court's Memorandum Opinion of even date, it is hereby:

**ORDERED, ADJUDGED AND DECREED** that:

1. For assets upon which there is no dispute as to the validity and perfection of a lien, any credit bid amount under § 363(k) of the Bankruptcy Code is hereby limited, for cause shown, to $1,200,000 for the assets related to the Debtors' radio business and $12,700,000 for the assets related to the Debtors' newspaper and printing businesses.

2. In order to take advantage of any credit bid right, the proponent thereof must first provide proof that the Debtors and the Official Committee of Unsecured Creditors agree is sufficient, or if there is a disagreement as to the sufficiency of the proof, proof the Court concludes is sufficient, that it is indeed the lender who

holds the Draw Commercial Note dated September 11, 2007, made by the Debtors payable to the order of BB&T in **[**30]** the original principal amount of $45,842,400 evidencing the indebtedness and resulting claim in this case, which would give rise to any credit bid right at all pursuant to 11 U.S.C. 363(k).

3. The Sale Hearing to consider approval of the sale as contemplated in the Sale Procedures Orders will be conducted on May 22, 2014, at 11:00 a.m. (Eastern time), or such other date and time as may be convenient to the Court, or as may be announced at the Sale Hearing without further notice.

4. The Court shall retain jurisdiction over any matter or dispute arising from or relating to the implementation of this Order.

Let the Clerk send a copy of this Order to all counsel of record.

ENTERED: April 14, 2014

/s/ Kevin R. Huennekens

UNITED STATES BANKRUPTCY JUDGE

ENTERED ON DOCKET

April 14, 2014

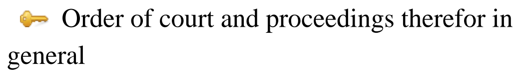
# TAB 19

2009 WL 1371950
Only the Westlaw citation is currently available.
United States Bankruptcy Court, D. Hawai'i.

In re ALOHA AIRLINES, INC., a Delaware corporation, et al., Debtor.
This document relates to: All Cases.

No. 08–00337. | Related Dkt. No. 1347. | May 14, 2009.

West KeySummary

1 **Bankruptcy**

Order of court and proceedings therefor in general

A Chapter 7 trustee was not entitled to approval of proposed bidding and sales procedures for the sale of the debtor airline's intellectual property. The probable purchaser under the proposed procedures had entered into a settlement agreement with a competing airline. That settlement required the probable purchaser to license the debtor's intellectual property to a competing airline for at least ten years. The competing airline had entered into the debtor's inter-island air market with the intention of forcing the debtor out of business and with the advantage of confidential information obtained from the debtor and a third airline. Further, the competing airline had attempted to conceal its misbehavior by document destruction and false statements under oath. The court concluded that it could not allow its authority to be misused in a way that would reward the competing airline for its misconduct. 11 U.S.C.A. § 105(a).

2 Cases that cite this headnote

**Attorneys and Law Firms**

Brian G. Rich, Berger Singerman PA, Tallahassee, FL, Jordi Guso, Paul Steven Singerman, Berger Singerman PA, Miami, FL, Marshall S. Sinick, Squire, Sanders & Demsey LLP, Washington, DC, Neil J. Verbrugge, Wagner Choi & Verbrugge, Honolulu, HI, for Debtor.

***MEMORANDUM OPINION REGARDING TRUSTEE'S RENEWED MOTION CONCERNING SALE OF DEBTOR'S INTELLECTUAL PROPERTY***

LLOYD KING, Bankruptcy Judge.

## I. INTRODUCTION

***1** This is a liquidating bankruptcy under chapter 7 of the Bankruptcy Code. [1] On March 20, 2008, the debtors [2] filed their voluntary petitions for reorganization under chapter 11 of the Bankruptcy Code. Shortly thereafter, on April 29, 2008, the case was converted to chapter 7. Prior to filing for bankruptcy, the debtors operated an airline company based in the state of Hawaii, Aloha Airlines, which provided passenger and air cargo services, as well as local assistance to other airlines with operations in Hawaii.

On April 28, 2009, the court heard a renewed motion (the “Renewed Motion”) by the trustee in bankruptcy (the “Trustee”) for an order approving competitive bidding and sales procedures for the sale of Aloha's intellectual property (the “IP”). The IP includes the “Aloha Airlines” name, aircraft painting specifications, Aloha's frequent flyer programs, web sites, and numerous related trademarks and service marks (docket no. 1347–1, pp. 23–32). Ownership of the IP will enable any airline company to fly as Aloha Airlines.

A renewed motion was necessary because the court disallowed the results of a prior auction sale, due to the exclusion of a newspaper reporter from the auction (docket no. 1328). The prior auction was not “public” as required by Fed. R. Bankr.P. 6004(f)(1).

Most motions for approval of sales procedures are routine and uncontested. The Renewed Motion, however, is seriously contested because the entity identified as the probable purchaser is contractually bound to license the IP to another airline company, which is alleged to have contributed to the failure of Aloha's businesses. Among those opposing the Renewed Motion are the unions representing Aloha's former employees and former owners of Aloha.

The Renewed Motion was heard on April 28, 2009. Appearing in support of the motion were Chuck C. Choi, Wagner Choi & Verbrugge, for Dane S. Field, the Trustee

and Robert A. Klyman, Latham & Watkins, for prospective purchasers, Yucaipa Corporate Initiatives Fund I, L.P. and Yucaipa Corporate Initiatives Fund I, LLC. (collectively, "Yucaipa") Appearing in opposition to the motion were Rebecca L. Covert, Takahashi Vasconcellos & Covert, for the International Association of Machinists and Aerospace Workers Local Lodge 1245 ("Machinists Union"); Kurt K. Leong, Ogawa, Lau, Nakamura & Jew, and, telephonically, Jeffrey A. Bartos, Guerrieri, Edmond, Clayman & Bartos, for the Association of Flight Attendants–CWA, AFL–CIO ("Flight Attendants Union"); and Tina L. Colman, Alston, Hunt, Floyd & Ing, for the Ing Family Partnership, former owners of Aloha. [3]

**FACTS**

Some of the facts discussed below are found in documents filed in this bankruptcy court and the United States District Court for the District of Hawaii, of which this bankruptcy court is a unit. (28 U .S.C. § 151). The sources of facts from documents not part of the record in the Aloha bankruptcy case are: *Aloha Airlines, Inc., et al. v. Mesa Air Group, Inc.,* United States District Court for the District of Hawaii, Case No. CV 07–00007 DAE/BMK ("*Aloha v. Mesa* "), and *Hawaiian Airlines, Inc., v. Mesa Air Group, Inc.,* United States Bankruptcy Court for the District of Hawaii, Adversary Proceeding No. 06–90026 ("*Hawaiian v. Mesa* "). There has been no hearing concerning the use of such documents. Federal Rule of Evidence 201(e) permits any party to request a hearing, even after judicial notice has been taken.

***2** The inter-island airline business in Hawaii has, for many years, been intensely competitive. The two oldest and largest companies, Hawaiian Airlines ("Hawaiian") and Aloha have each been in bankruptcy twice. After two chapter 11 cases in this court, No. 93–01072 and No.03–00817, Hawaiian is still in business, providing air transportation inter-island in Hawaii, as well as service to the U.S. mainland, and other destinations. Aloha continued in business after its first chapter 11 case, No. 04–03063.As part of that reorganization of Aloha, Yucaipa became the owner of a controlling interest Aloha's corporate stock. [4]

The current Aloha bankruptcy case, in which this Renewed Motion by the Trustee is pending, is Aloha's second bankruptcy. It was filed as a voluntary Chapter 11 reorganization on March 20, 2008. Shortly thereafter, on March 31, 2008, Aloha abruptly terminated passenger operations. Aloha's air cargo business continued and was soon sold separately, as a going business. Aloha's chapter 11 case was converted to a liquidating bankruptcy on April 29, 2008, and Dane S. Field was appointed to serve as trustee by the Office of the United States Trustee.

Aloha started its airline operations in 1946. At the time of the filing of Aloha's second bankruptcy petition, it had approximately 3,500 employees. The sudden termination of passenger operations cost most of these employees their jobs, essentially without warning. Many had decades of service with Aloha. Some families were especially hard hit, as both spouses worked for Aloha. Wages were not the only loss, as most employees had job related health insurance.

At the first hearing in this case, on March 21, 2008, Aloha attributed its problems to the predatory behavior of Mesa Air Group, Inc. ("Mesa") and to greatly increased fuel costs.

Mesa started inter-island passenger air service in June, 2006, through its go! subsidiary ("go!"). Before entering the Hawaii market, Mesa obtained valuable information from both Hawaiian and Aloha, subject to confidentiality agreements. That information was useful to Mesa in making its decision concerning entering the Hawaii market. Mesa and Hawaiian entered into a confidentiality agreement in March, 2004. Mesa and Aloha entered into confidentiality agreements in January, 2005, and January, 2006.

Hawaiian filed the complaint in *Hawaiian v. Mesa* on February 13, 2006, seeking damages, the return of confidential materials and an injunction preventing Mesa from entering into the Hawaii air market. [5] During the course of that litigation, Mesa falsely claimed that it had not misused confidential information obtained from Hawaiian. The court found that:

> From the inception of this case, Mesa attempted to create the impression that it has scrupulously obeyed the letter and spirit of the confidentiality agreement. Mesa went so far as to attach to its initial pleading a declaration from its chief financial officer ..., in which [he] described in great detail the painstaking care which he claimed he had taken to preserve any confidential information which Mesa got from [Hawaiian]. Mesa's story began to unravel when a

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> sharp-eyed attorney with [Hawaiian's counsel] read a document that Mesa produced in discovery and thought that it seemed familiar. Further checking revealed that, when Mesa prepared an offering memorandum seeking financing for its new Hawaii operations, it copied verbatim large portions of the information memorandum that Hawaiian had given to Mesa under the protection of the confidentiality agreement.

***3** *Hawaiian v. Mesa,* docket no. 563, p. 9–10.

The Hawaiian litigation against Mesa revealed more dishonesty by Mesa, this time concerning Aloha. This court stated, in a footnote:

> At least at one time, Mesa hoped to drive [Aloha] out of business. [Mesa's executive vice-president and chief financial officer] stated in a declaration that '[a]t no time did Mesa base its business plan or decision to enter the Hawaii inter-island market on [Aloha] or [Hawaiian] exiting this market'. In his deposition, he said that Mesa had not even done any analysis to determine what would happen to Mesa's business if [Aloha] were to cease operations. Both statements are false. One week before Mesa announced that it planned to enter the inter-island market, [he] wrote, in an email to [a Mesa consultant], I agree that if we assume [Aloha] stays in the market and in business forever, this project makes no sense. We definitely don't want to wait for them to die, rather we should be the ones who give them the last push.... Clearly if we can get [Aloha] out of the market without anyone else stepping in this is a homerun.' Similarly, Hawaiian has proven that, contrary to sworn testimony, the Mesa consultant prepared a set of projections based on the assumption that [Aloha] would reduce its flights and go out of business.

*Hawaiian v. Mesa,* docket no. 120, pp. 25–6, n. 5.

There was still more Mesa misconduct before this court in the Hawaiian adversary proceeding against Mesa. Destruction of electronic evidence by use of a disk scrubber is described in detail in the *Hawaiian v. Mesa,* Findings of Fact and Conclusions of Law on Motion for Sanctions. (*Hawaiian v. Mesa,* docket no. 451). The day after that lawsuit was filed, an attorney advised Mesa's top executives to "preserve any and all documents that may be related to the matters set forth in the Complaint including emails, electronic documents, notes, models etc."*Id.* at p. 5, ¶ 9.b .i..

Despite the warning from counsel, the executive vice-president and chief financial officer of Mesa used DiskScrubber2 or a similar program to render unrecoverable any deleted files on two computers and changed the system clocks of the computers in an attempt to conceal the fact of the deletions. *Id.* at p. 4–5, ¶ 8. The court found that "Mr. Murnane's destruction of evidence was intentional, deliberate, willful, and in bad faith."*Id.* at p. 5, ¶ 9. Mesa facilitated this misconduct by failing to take reasonable steps that would have prevented or mitigated the consequences of the destruction of evidence. *Id.* at p. 11, ¶ 13.

After trial of Hawaiian's adversary proceeding against Mesa in this bankruptcy court, Hawaiian was given judgment against Mesa in the amount of $80,000,000.(*Hawaiian v. Mesa,* docket no. 453. entered October 30, 2007). Later, Hawaiian was awarded an additional $3,929,532.21, for attorneys' fees and costs (*Hawaiian v. Mesa,* docket no. 563). Mesa filed a notice of appeal and posted an appeal bond. While the appeal was pending before the United States District Court for the District of Hawaii, the litigation was settled by the payment of $52,500,000 to Hawaiian (*Hawaiian v. Mesa,* docket no. 591).

***4** On January 9, 2007, while the Hawaiian litigation with Mesa was pending, Aloha filed a lawsuit against Mesa in the United States District Court for the District of Hawaii, *Aloha Airlines, Inc., et al. v. Mesa Air Group, et al.,* CV07–00007 DAE LEK. ("*Aloha v. Mesa* "). The complaint accuses Mesa of "improper predatory pricing and unfair competition designed to drive [Aloha] out of business and Mesa's improper retention and use of Aloha's valuable trade secrets and proprietary information to compete unfairly against Aloha in violation of various agreements."(*Aloha v. Mesa,* docket no. 1, p. 1, ¶ 4.)

Aloha filed its petition for reorganization in this bankruptcy case on March 20, 2008, over a year after filing its complaint in *Aloha v. Mesa.*After Aloha's chapter 11 reorganization case was converted to a liquidating bankruptcy under chapter 7, the Trustee elected to sell the lawsuit, rather than have the bankruptcy estate continue the litigation. The purchaser of the lawsuit was Yucaipa, which made a credit bid of $10,000,000, against its total secured claim of close to $100,000,000. On June 27, 2008, an order was entered in this bankruptcy case authorizing the sale. (docket no. 840).

Aloha's former counsel, in *Aloha v. Mesa,* Latham & Watkins, continued to represent the plaintiff's position after it was purchased by Yucaipa. Latham & Watkins now represents Yucaipa in its efforts to complete its purchase of the Aloha IP and the license of the Aloha identity to Mesa.

On November 28, 2008, Yucaipa and Mesa entered into a settlement and release agreement ("Settlement Agreement"). The full terms of the Settlement Agreement are not part of the record in this matter, but Yucaipa has filed in this bankruptcy case a partial disclosure entitled, 'Notice of Filing Terms of Settlement Agreement between Yucaipa and Mesa Airlines,' indicating that it contained the 'economic and licensing terms' of the settlement. (docket no. 1260). The disclosed portion of the settlement appears to be divided into two parts, a release given by Yucaipa to Mesa of all claims related to the lawsuit and a license to Mesa of the Aloha IP. [6]

Under the disclosed terms of the Settlement Agreement, consideration for Mesa's release is stated to be a cash payment of $2 million and the issuance to Yucaipa of 2,692,800 shares of Mesa Air Group. As consideration for the 10 year IP license, Mesa promises to pay to Yucaipa a minimum of $600,000 per year for the term of the lease. That amount can be increased, depending upon Mesa's profitability. [7] To give Yucaipa some assurance of payment from the licensing fees, it is also to receive a back-up secured promissory note in the amount of $5 million.

Yucaipa and Mesa entered into the Settlement Agreement on Friday, November 28, 2008, just days before the December 2, 2009, auction of the Aloha IP and the December 3, 2009 court hearing to approve and confirm the results of the auction. The Trustee was not a party to the *Aloha v. Mesa* settlement or negotiations leading to the Settlement Agreement. Upon public disclosure, the terms of the Settlement Agreement, especially the proposed license of the Aloha name, received local media attention.

***5** Previously, on November 19, 2008, the court had entered an unopposed order approving bid procedures similar to those now proposed by the Trustee in this Renewed Motion. (docket no. 1232). The Aloha IP is part of the collateral for Yucaipa's secured claim, and the order approving bid procedures allowed Yucaipa to credit bid, up to the amount of the secured claim. The unpaid amount of the Yucaipa secured claim is estimated to be in the range of $85 million to $90 million. The Trustee and Yucaipa agreed to a sale price to Yucaipa of $500,000, plus $50,000 in cash to the estate. An auction sale would be held, only if there was a qualifying overbid. Hawaiian made a qualifying overbid of $575,000, cash, so an auction sale was necessary.

The auction was held on Tuesday, December 2, 2008, at the offices of the Trustee's counsel. The bidding started with Hawaiian's bid of $575,000. Yucaipa made an increased bid of $750,000. There were no further bids. The Trustee closed the auction and declared Yucaipa to be the high bidder.

The next day, Wednesday, December 3, 2008, the court heard the motion to confirm the auction sale of Aloha's IP. By that date, there was public awareness of the preceding Friday's Yucaipa–Mesa settlement and the proposed license of Aloha's IP to Mesa. Because of this very recent development, the court continued the auction confirmation hearing to March 3, 2009.

On December 3, 2008, a few hours after the first auction confirmation hearing, the court received correspondence from a Honolulu Advertiser reporter, stating that he had been denied permission to attend the auction. After this fact was confirmed, the auction sale was declared invalid, because it was not a public auction sale, as required by Fed. R. Bankr.P. 6004(f)(1) (docket nos. 1328, 1329). [8] Because the auction sale was declared invalid, the court did not consider objections to the sale to Yucaipa and the accompanying IP license to Mesa.

Since objections to the proposed Yucaipa–Mesa license had been filed, but not considered, the court ordered those objections to be heard at the same time as the Trustee's motion to conduct another auction (docket no. 1343).

On March 24, 2009, the Trustee filed the Renewed Motion, seeking approval of the Asset Purchase Agreement between the Trustee and Yucaipa and, in the event of a qualified overbid, an auction sale (docket no. 1347).

The Renewed Motion was heard on April 28, 2009. The Machinists' Union, the Flight Attendants' Union, and the Ing Family Trust continue to oppose a sale to Yucaipa, which would include a license to Mesa. All argue that the successful effort of Mesa to drive Aloha out of business means that a license, which would allow Mesa to operate as Aloha, is not in good faith. The Machinists Union also argues that the Trustee is incapable of selling Aloha's IP to anyone, because a sale of Aloha's name and goodwill must be accompanied by a sale of tangible assets. The Flight Attendants' Union argues that

any license to Mesa must include terms more favorable to Aloha's former employees than six “space available” round-trip interisland tickets per year for the term of the license. Hawaiian, did not object to the Renewed Motion.

***6** The Trustee's Renewed Motion was argued and submitted on April 28, 2009.

## II. ISSUE

Can the past misconduct of a prospective purchaser of property of a bankruptcy estate disqualify that entity from acquiring property of a bankruptcy estate?

## III. DISCUSSION

### A. *Standing of the Parties Objecting to the Trustee's Renewed Motion*

Yucaipa challenges the standing of the former employees' unions and former owners of Aloha to object to the terms of sale of the Aloha IP.

The answer to this objection starts with the fact that the former employees are parties in interest in the Aloha bankruptcy case. Two adversary proceedings have been filed in this court, alleging that the sudden, mass termination of the jobs of Aloha employees was done in violation of the Worker Adjustment and Retraining Notification Act, 28 U.S.C. §§ 2101–2109 (the “WARN Act”).

The Flight Attendants' Union is plaintiff in adversary proceeding no. 08–90038, the Association of Flight Attendants–CWA, AFL–CIO, filed July 7, 2008. The other WARN Act adversary proceeding is *Stoker, et al., v. Aloha Airlines, Inc., et al.,* adv. pro. no. 08–00018, filed April 8, 2008 (“*Stoker v. Aloha*”). Stoker was filed as a class action on behalf of all terminated employees, but no class has yet been certified.

The WARN Act lawsuits give to all former employees claims against the Aloha bankruptcy estate. Under the Bankruptcy Code, a ‘claim’ is a right to payment, even if unliquidated, contingent, or disputed. 11 U.S.C. § 101(5). As holders of claims, they are ‘creditors' in the bankruptcy case. 11 U.S.C. § 101(10). All creditors are entitled to notice of the proposed sale of property of the estate. (Fed. R. Bankr.P.2002(a)(2)). Creditors of an estate should be allowed to be heard concerning the sale of the estate's assets. No contrary authority has been provided. Former employees, through their unions, The Flight Attendants' Union and the Machinists Union, have standing to object to the proposed sale.

In addition to the standing of the unions, this court, as a court of equity, has both the power and the duty, *sua sponte,* to examine the facts surrounding this proposed sale of Aloha's IP. 11 U .S.C. § 105(a); *In re Davenport,* 175 B.R. 355, 361 (Bankr.E.D.Cal.1994); *In re Hale,* 980 F.2d 1176, 1179 (8th Cir.1992).

The objecting unions have standing to object to the proposed terms of sale of the Aloha IP. The court has the independent ability to review the propriety of the proposed terms of the Trustee's Renewed Motion. Therefore, Yucaipa's argument that the Trustee's Renewed Motion must be granted due to the objectors' lack of standing fails. This determination makes it unnecessary to rule upon the standing of the objecting former owners of Aloha, the Ing Family Partnership.

### B. *Mesa as a Co–Purchaser with Yucaipa*

The Trustee's Renewed Motion seeks approval of proposed procedures for the sale of Aloha's IP. The Trustee's proposed procedures allow Yucaipa to credit bid, and Yucaipa has an estimated $85 to $90 million available for such a bid. No qualified bidders have suggested offering as much as $1 million for the IP, so Yucaipa cannot be outbid. If Yucaipa wants the IP, it will be the successful bidder. There are no remaining assets of substantial value on which Yucaipa could use the remainder of its secured claim for a credit bid.

***7** Because Yucaipa is the probable purchaser under the procedures proposed by the Trustee's Renewed Motion and because the connection between Yucaipa and Mesa has become a matter of some controversy, the court has decided to face the issue of Mesa's license from Yucaipa before, rather than after, the proposed sale has been completed by the Trustee and presented to the court for approval.

For purposes of this discussion, it is assumed that there are two proposed purchasers [9] of the Aloha IP, Yucaipa and Mesa. The agreement between the Trustee and Yucaipa for purchase of the Aloha IP attached to the Trustee's Renewed Motion (docket no. 1347–1) is between the Trustee and Yucaipa and contains no mention of Mesa. However, Yucaipa's Notice of Filing Terms of Settlement Agreement Between Yucaipa and Mesa Airlines (docket no. 1260, p. 2), states that, should Yucaipa be the successful purchaser, it is obligated to give a 10 year license of the IP to Mesa.

The record does not disclose whether or not Mesa has any renewal rights after the 10 year term, but a 10 year license is a very substantial interest in what the Trustee is offering for sale. If the Trustee's Renewed Motion is granted, Mesa, through its go! subsidiary, will be able to become 'Aloha Airlines' for at least 10 years. Under the agreement between the Trustee and Yucaipa, whereby Yucaipa purchased the *Aloha v. Mesa* lawsuit, the bankruptcy estate will receive 5% of Yucaipa's net recovery from Mesa, so the estate should get a portion of any licensing fees paid by Mesa for Aloha's IP. Mesa is both giving and receiving value in connection with the Trustee's proposed sale of Aloha's IP (docket no. 840–1, Art. 4.2B).

"Decisional law tells us that the first requirement of a 'good faith' purchaser is that there be an identifiable purchaser."*In re Thomas,* 287 B.R. 782, 785 (Bankr.9th Cir.2002). The Trustee's Renewed Motion misidentifies only Yucaipa as the prospective purchaser. Actually, there are two would-be purchasers, Yucaipa and Mesa. The fact that such a substantial portion of what is to be sold by the Trustee will go to Mesa cannot be ignored. Mesa is a co-purchaser with Yucaipa.

**C.** ***Statutory 'Good Faith' 11 U.S.C. § 363(m)***

The only statutory use of the term 'good faith' concerning sales of property of a bankruptcy estate is in 11 U.S.C. § 363(m). If an order authorizing a sale is reversed on appeal, that section provides a safe harbor to 'an entity that purchased or leased such property in good faith'. Interest in protecting the integrity and finality of bankruptcy court sales favors the protection of 'good faith' purchasers.

The term 'good faith' is not defined in the Bankruptcy Code, but case law has decided that it means purchasing for value, in good faith and without notice of adverse claims. *In re Gucci,* 126 F.3d 380, 394 (2nd Cir.1997). The Trustee's Renewed Motion does not concern a sale that has occurred or an appeal from an order authorizing a sale. Therefore, in discussing the consequences of misconduct by a prospective purchaser, it is best to leave the statutory term 'good faith' to the confines of § 363(m). While there may be some conceptual overlap, use of the term 'good faith' at this time is not required.

**D.** ***The Bankruptcy Court as a Court of Equity***

***8** In discussing purchasers' attempts to escape the terms of a bankruptcy sale, a bankruptcy court stated, "This court, as it has been so frequently reminded, sits as a court of equity and examines the facts before it with such principles in mind, for its equitable power extends to more than the typical dispute and pervades bankruptcy administration."*In re M & M Transportation Company,* 13 B.R. 861, 867, (Bankr.S.D.N.Y.1981) (citations omitted). In that case, there was no misconduct, and it was the court approved purchasers who were trying to nullify their purchase of motor carrier operating rights. After the sale and before full payment to the trustee, deregulation of the trucking industry greatly devalued the rights. The purchasers sought equitable relief from their obligations to pay the trustee. The court granted the trustee's motions for summary judgment requiring payment for the rights. In *M & M,* legal rights prevailed over equitable claims because, "[m]indful of all this, the court can only reaffirm the observation that the legal process and the equity process do not necessarily lead to the same result".*Id.* at 868.

In cases where equitable arguments prevail, over a legal position, there is usually some form of misconduct by the party relying on the legal position. The most well known bankruptcy case in this regard is *Pepper v. Litton,* 305 U.S. 295 (1939).

In that case, an insider had a claim for back salary, supported by a state court judgment. *Id.* The Court found that there was a scheme by the insider to defeat a debt owing to a legitimate creditor and reversed the court of appeals ruling upholding the insider's claim. *Id.*

"No matter how technically legal each step in that scheme may have been, once its basic nature was uncovered, it was the duty of the bankruptcy court in the exercise of its equity jurisdiction to undo it. Otherwise ... equity would be perverted as an instrument for approving what it was designed to thwart."*Id.* at 312.

There are, of course, limits on the use of equitable powers in bankruptcy. In *Norwest Bank Worthington v. Ahlers,* 485 U.S. 197, 108 S.Ct. 963, 99 L.Ed.2d 169 (1988), the court disapproved the use of equitable powers to nullify the absolute priority rule of reorganizations under Chapter 11. The court observed that, "Whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code".*Id.* at 206.Therefore, a bankruptcy court cannot deny to a creditor rights specifically accorded by the Code.

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Yucaipa is not being denied any rights specifically given to it by the Bankruptcy Code. The closest Code provision appears to be 11 U.S.C. § 363(k), which allows lien holders to make credit bids, "unless the court for cause orders otherwise...." Yucaipa's sponsorship of Mesa's acquisition of a substantial interest in the Aloha IP constitutes 'cause' to deny Yucaipa the ability to credit bid, as proposed in the Trustee's Renewed Motion. Standing alone, with no connections to Mesa and appropriate assurance that no interest in the Aloha IP would ever pass to Mesa, there is no apparent cause to deny to Yucaipa the ability to credit bid. However, since the Trustee's Renewed Motion and the attached Asset Purchase Agreement do not identify Mesa as a co-purchaser or even mention the license of the IP which Yucaipa is obligated to give to Mesa, cause exists to deny the credit bid, and neither subdivision (k) or any other provision of § 363 gives to Yucaipa any rights which are immune to a bankruptcy court's equitable powers.

***9** *In re Grodel Manufacturing, Inc.,* 33 B.R. 693 (Bankr.D.Conn.1983), discusses court approval or disapproval of a prospective purchaser, on terms favorable to the bankruptcy estate, before a sale has taken place. In disapproving a potential sale to a former trustee, the court observed, "Notwithstanding any financial merits of a proposed sale to a former trustee and without taking into account proof of any wrongdoing by a former trustee, such a sale carries with it such a graphic appearance of impropriety that the prudent course for courts to follow is to prohibit the transaction or invalidate its occurrence."*Id.* at 696.

Given the prior conduct of co-purchaser Mesa, this court, as a court of equity must prohibit the sale proposed by the Trustee's Renewed Motion.

**E.** ***Adequacy of the Record as to Mesa Misconduct***

The concerning Mesa's behavior require court of equity to refuse to approve the sale of the IP to Mesa through Yucaipa.

The record demonstrates that Mesa entered the Hawaii inter-island air market with the intention of forcing Aloha out of business. It was aided in this effort by information obtained through confidential agreements with both Hawaiian and Aloha. The information obtained from Hawaiian was misused by Mesa to support its plan to enter the Hawaii air market. In the *Hawaiian v. Mesa* adversary proceeding in this court, Mesa relied upon sworn misstatements, which were intended to cover the truth concerning its dishonesty and destruction of records.

Mesa succeeded in inflicting great harm, not only upon the Aloha corporate entities, but also upon thousands of Aloha employees and their families. Now, through Yucaipa, Mesa seeks to perfect its wrongdoing by becoming Aloha.

While no cases have been found with comparable facts, it is difficult to imagine a court overlooking what Mesa has done and putting its stamp of approval on Mesa's subsidiary, go!, becoming Aloha.

It does not help Mesa's cause that it attempts to sneak into Aloha's identity under the cover of Yucaipa's proposed credit bid. A loss to Yucaipa of the licensing fees from Mesa will accompany a refusal to allow Yucaipa to bid for itself and for Mesa, but Yucaipa must have known that some parties would find its dealings with Mesa to be highly objectionable. The bankruptcy estate, which is entitled to 5% of Yucaipa's net recovery from the *Aloha v. Mesa* litigation, will lose that share of the licensing fees. However, the financial merits are not a sufficient reason for a court to allow an improper sale of property of a bankruptcy estate. *In re Grodel Manufacturing, Inc.,* 33 B.R. at 696.

In the context of a challenge to the good faith of a purchaser, the 9th Circuit BAP has suggested the possibility of an evidentiary hearing to review the conduct of the purchaser. *In re Thomas,* 287 B.R. 782.Usually, an evidentiary hearing is the best way to get a full picture of a party's actions. However, this is not the usual case. Mesa has destroyed records and attempted to cover up the destruction. After the district court settlement between Yucaipa and Mesa, it would be surprising to find much of anything still in existence related to Mesa's entry into the Hawaii air market. As a further complication, Mesa's past dishonesty in this court will surround any hearing in which its veracity is at issue with an atmosphere of disbelief. In other words, an evidentiary hearing would serve no purpose.

**F.** ***Remaining Arguments***

***10** Because the Trustee's Renewed Motion is to be denied for the reasons explained above, the court need not consider the two remaining arguments raised by the objectors.

**G.** ***Conclusion***

The Trustee's Renewed Motion for sale of the Aloha IP is presented as a proposed sale to Yucaipa, on a credit bid that cannot be defeated. However, because of the Settlement Agreement between Yucaipa and Mesa, Yucaipa is bound

to license the Aloha IP to Mesa for at least 10 years. The full Settlement Agreement is not part of the record, so Mesa's rights, if any, upon expiration of the 10 year term are unknown.

The fact that Mesa is to receive a very substantial interest in the Aloha IP makes Mesa a co-purchaser with Yucaipa, for purposes of evaluating the proposed bid procedures. It is therefore necessary to consider the prior conduct of both Yucaipa and Mesa. There has been no suggestion of affirmative misconduct by Yucaipa. When Yucaipa purchased Aloha during its first bankruptcy case, it appears to have made an unfortunate investment, but that is not misconduct.

Mesa, on the other hand, entered the Hawaii inter-island air market with the intention of forcing Aloha out of business and with the advantage of confidential information obtained from both Hawaiian and Aloha. Mesa attempted to conceal its misbehavior by document destruction and false statements, made under oath.

Unions representing former employees who hold claims against the estate have objected to allowing Mesa to perfect its misconduct by letting Mesa's subsidiary, go!, become Aloha Airlines.

This court has an independent power and duty to examine the propriety of a proposed sale of property of a bankruptcy estate, and it cannot allow its authority to be misused in a way that would reward Mesa for its misconduct.

The Trustee's Renewed Motion will be denied.

1 Three related cases are being jointly administered under the name and number of this case (docket no. 44). The other related cases are, Aloha Airgroup, Inc., case no. 08–00338, and Airgroup Acquisition Corp., case no. 08–00339.For convenience, the singular word, ‘case’ will be used throughout.

2 Aloha Airlines, Inc., Aloha Airgroup, Inc., and Airgroup Acquisition Corp. (collectively, “Aloha”).

3 There has also been informal opposition: (1) The signatures of approximately 260 former employees are included in docket no. 1298, Objections by Former Employees of Aloha Airlines to Trustee's Proposed Sale of Intellectual Property; and (2) The declaration of Randolph J. Kauhane, full-time representative of Machinists Union Lodge 1245, states that the Union has received objecting petitions, with over 4,000 signatures (docket no. 1296–3).

4 Debtor Aloha Airlines, Inc., is 100% owned by debtor Aloha Airgroup, Inc. Debtor Aloha Airgroup, Inc., is 100% owned by debtor Airgroup Acquisition Corp. Yucaipa is the 67.557% effective owner of Airgroup Acquisition Corp. List of Equity Security Holders in Airgroup Acquisition Corp. (No. 08–00339, docket. no. 3).

5 The presiding bankruptcy judge in both the Hawaiian Chapter 11 case, no. 03–00817, and the *Hawaiian v. Mesa* adversary proceeding was Hon. Robert J. Faris, not the undersigned.

6 “Under the Settlement Agreement [between Yucaipa and Mesa], upon the consummation of Yucaipa's acquisition of Aloha's rights, title and interest in the ‘Aloha’ name and the ‘Aloha Airlines' name (the ‘Assets'), Yucaipa will enter into an agreement with Mesa (the ‘Licensing Agreement’) whereby Yucaipa will license the Assets to Mesa for 10 years (the ‘Term’).” (Docket. no. 1260, p. 2.)

7 Also, for the 10 year term of the license agreement, “Mesa will issue 6 space available free round trip passes per year to each Aloha employee, as of the date of Aloha's bankruptcy filing....” (Docket no. 1260, p. 2.)

8 At the hearing to determine whether or not the Trustee's December 2, 2008, auction sale to Yucaipa should be set aside, counsel for the Machinists Union stated that Randolph J. Kauhane, the union's full-time representative, was also denied access to the auction (docket no. 1328). Counsel for the Trustee and Yucaipa were present at the hearing and did not dispute the allegation.

9 Under the Bankruptcy Code, “The term ‘purchaser’ means transferee of a voluntary transfer, and included immediate or mediate transferee of such a transferee.”11 U.S.C. § 101(43).

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# TAB 20

2014 ONSC 4777
Ontario Superior Court of Justice [Commercial List]

Nortel Networks Corp., Re

2014 CarswellOnt 17193, 2014 ONSC 4777, 121 O.R. (3d) 228, 247 A.C.W.S. (3d) 267

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

In the Matter of a Plan of Compromise or Arrangement of Nortel Networks Corporation, Nortel Networks Limited, Nortel Networks Global Corporation, Nortel Networks International Corporation and Nortel Networks Technology Corporation

Application under the Companies' Creditors Arrangement Act, R.S.C. 1985, c. C-36, as Amended

Newbould J.

Heard: July 25, 2014
Judgment: August 19, 2014
Docket: 09-CL-7950

Counsel: Benjamin Zarnett, Graham Smith for Monitor and Canadian Debtors
Ken Rosenberg for Canadian Creditors' Committee
Michael Barrack, D.J. Miller, Michael Shakra for UK Pension Claimants
Tracy Wynne for EMEA Debtors
Kenneth Kraft for Wilmington Trust, National Association
Richard Swan, Gavin Finlayson, Kevin Zych for Ad Hoc Group of Bondholders
Shayne Kukulowicz for US Unsecured Creditors' Committee
John D. Marshall for Law Debenture Trust Company of New York
Brett Harrison for Bank of New York Mellon
Andrew Gray, Scott Bomhof for US Debtors

Subject: Insolvency

## Headnote

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

Post-filing interest — Unsecured bonds were issued that were guaranteed by Canadian corporation, N Corp., and related U.S. corporations (subject bonds) — N Corp. was granted protection under Companies' Creditors Arrangement Act (CCAA), and related U.S. corporations filed for bankruptcy — Holders of subject bonds (bondholders) commenced CCAA claims for principal and pre-filing interest in amount of US$4.092 billion, as well as post-filing interest of approximately US$1.6 billion — Trial was ordered on issue of whether bondholders were entitled to claim post-filing interest — Ruling issued — It was held that bondholders were not legally entitled to claim or receive any amounts beyond outstanding principal debt and pre-petition interest — Post-filing interest was not legally payable on subject bonds — There was no reason to not apply common law "interest stops rule" to CCAA proceeding because CCAA did not expressly provide for its application — Interest stops rule had been applied in winding-up cases in spite of fact that legislation did not provide for it — There was no controlling authority in Canada in case such as this in which there was contested claim being made by bondholders for post-filing interest against insolvent estate under CCAA — However, in recent Supreme Court of Canada decisions, court indicated that it favoured interpretations of Bankruptcy and Insolvency Act and CCAA that gave creditors analogous entitlements — Taking direction from those decisions, there was no reason not to apply interest stops rule in

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liquidating CCAA proceedings — There was no provision in CCAA that would not permit application of rule — Cases relied on by bondholders as authority that interest stops rule did not apply in CCAA proceeding were distinguishable.

**Table of Authorities**

**Cases considered by *Newbould J.*:**

*Abacus Cities Ltd. (Trustee of) v. AMIC Mortgage Investment Corp.* (1992), [1992] 4 W.W.R. 309, 125 A.R. 45, 14 W.A.C. 45, 1 Alta. L.R. (3d) 257, 89 D.L.R. (4th) 84, 11 C.B.R. (3d) 193, 1992 CarswellAlta 281 (Alta. C.A.) — considered

*AbitibiBowater Inc., Re* (2009), 2009 CarswellQue 14224, 2009 QCCS 6461 (C.S. Que.) — considered

*Canada (Attorney General) v. Confederation Life Insurance Co.* (2001), [2001] O.T.C. 486, 2001 CarswellOnt 2299 (Ont. S.C.J. [Commercial List]) — considered

*Humber Ironworks & Shipbuilding Co., Re* (1869), 4 Ch. App. 643 (Eng. Ch. Div.) — considered

*Indalex Ltd., Re* (2009), 2009 CarswellOnt 4465, 55 C.B.R. (5th) 64, 79 C.C.P.B. 104 (Ont. S.C.J. [Commercial List]) — referred to

*Indalex Ltd., Re* (2013), 2013 SCC 6, 2013 CarswellOnt 733, 2013 CarswellOnt 734, 354 D.L.R. (4th) 581, 2 C.C.P.B. (2nd) 1, 96 C.B.R. (5th) 171, (sub nom. *Sun Indalex Finance LLC v. United Steelworkers)* [2013] 1 S.C.R. 271, 20 P.P.S.A.C. (3d) 1, 439 N.R. 235, D.T.E. 2013T-97, 301 O.A.C. 1, 8 B.L.R. (5th) 1 (S.C.C.) — considered

*Ivaco Inc., Re* (2006), 2006 C.E.B. & P.G.R. 8218, 25 C.B.R. (5th) 176, 83 O.R. (3d) 108, 275 D.L.R. (4th) 132, 2006 CarswellOnt 6292, 56 C.C.P.B. 1, 26 B.L.R. (4th) 43 (Ont. C.A.) — referred to

*Lehndorff General Partner Ltd., Re* (1993), 17 C.B.R. (3d) 24, 9 B.L.R. (2d) 275, 1993 CarswellOnt 183 (Ont. Gen. Div. [Commercial List]) — considered

*NAV Canada c. Wilmington Trust Co.* (2006), 2006 CarswellQue 4890, 2006 CarswellQue 4891, 2006 SCC 24, (sub nom. *Greater Toronto Airports Authority v. International Lease Finance Corp.)* 80 O.R. (3d) 558 (note), (sub nom. *Canada 3000 Inc., (Bankrupt), Re)* 349 N.R. 1, (sub nom. *Canada 3000 Inc., Re)* [2006] 1 S.C.R. 865, 10 P.P.S.A.C. (3d) 66, 20 C.B.R. (5th) 1, (sub nom. *Canada 3000 Inc. (Bankrupt), Re)* 212 O.A.C. 338, (sub nom. *Canada 3000 Inc., Re)* 269 D.L.R. (4th) 79 (S.C.C.) — considered

*Nortel Networks Corp., Re* (2010), 2010 CarswellOnt 8773 (S.C.C.) — referred to

*Nortel Networks Corp., Re* (2012), 88 C.B.R. (5th) 111, 2012 CarswellOnt 3153, 2012 ONSC 1213, 66 C.E.L.R. (3d) 310 (Ont. S.C.J. [Commercial List]) — considered

*Savin, Re* (1872), 7 Ch. App. 760 (Eng. Ch. Div.) — followed

*Shoppers Trust Co. (Liquidator of) v. Shoppers Trust Co.* (2005), 74 O.R. (3d) 652, 2005 CarswellOnt 1071, (sub nom. *Shoppers Trust Co. (Liquidation), Re)* 195 O.A.C. 331, 10 C.B.R. (5th) 93, 251 D.L.R. (4th) 315 (Ont. C.A.) — followed

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*Stelco Inc., Re* (2007), 2007 ONCA 483, 2007 CarswellOnt 4108, 35 C.B.R. (5th) 174, 32 B.L.R. (4th) 77, 226 O.A.C. 72 (Ont. C.A.) — considered

*Ted Leroy Trucking Ltd., Re* (2010), (sub nom. *Century Services Inc. v. Canada (A.G.))* [2010] 3 S.C.R. 379, [2010] G.S.T.C. 186, 12 B.C.L.R. (5th) 1, (sub nom. *Century Services Inc. v. A.G. of Canada)* 2011 G.T.C. 2006 (Eng.), (sub nom. *Century Services Inc. v. A.G. of Canada)* 2011 D.T.C. 5006 (Eng.), (sub nom. *Leroy (Ted) Trucking Ltd., Re)* 503 W.A.C. 1, (sub nom. *Leroy (Ted) Trucking Ltd., Re)* 296 B.C.A.C. 1, 2010 SCC 60, 2010 CarswellBC 3419, 2010 CarswellBC 3420, 409 N.R. 201, (sub nom. *Ted LeRoy Trucking Ltd., Re)* 326 D.L.R. (4th) 577, 72 C.B.R. (5th) 170, [2011] 2 W.W.R. 383 (S.C.C.) — considered

*Thibodeau v. Thibodeau* (2011), 87 C.C.P.B. 1, 73 C.B.R. (5th) 173, 331 D.L.R. (4th) 606, 2011 CarswellOnt 686, 2011 ONCA 110, 104 O.R. (3d) 161, 277 O.A.C. 359, 5 R.F.L. (7th) 16 (Ont. C.A.) — referred to

*Timminco Ltd., Re* (2014), 14 C.B.R. (6th) 113, 2014 ONSC 3393, 2014 CarswellOnt 9328 (Ont. S.C.J.) — considered

**Statutes considered:**

*Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3
Generally — referred to

*Bankruptcy Code*, 11 U.S.C. 1982
Chapter 11 — referred to

*Companies' Creditors Arrangement Act*, R.S.C. 1985, c. C-36
Generally — referred to

s. 11(1) — considered

*Excise Tax Act*, R.S.C. 1985, c. E-15
Generally — referred to

*Winding-up Act*, R.S.C. 1970, c. W-10
Generally — referred to

RULING on whether holders of unsecured bonds were entitled to claim post-filing interest under *Companies' Creditors Arrangement Act*.

***Newbould J.*:**

1 Nortel Networks Corporation ("NNC") and other Canadian debtors filed for and were granted protection under the *Companies' Creditors Arrangement Act*, R.S.C. 1985, c. c-36, ("CCAA") on January 14, 2009. On the same date, Nortel Network Inc. ("NNI") and other US debtors filed petitions in Delaware under the United States Bankruptcy Code, 11 U.S.C., Chapter 11.

2 Beginning in 1996, unsecured *pari passu* notes were issued under three separate bond indentures, first by a US Nortel corporation guaranteed by Nortel Networks Limited ("NNL"), a Canadian corporation, and then by NNL in several tranches jointly and severally guaranteed by NNC and NNI (the "crossover bonds"). Thus all of the notes are payable by Nortel entities in both Canada and the US, either as the maker or guarantor. Under claims procedures in both the Canadian and US proceedings, claims by bondholders for principal and pre-filing interest in the amount of US$4.092 billion have been made against each of

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the Canadian and US estates. The bondholders also claim to be entitled to post-filing interest and related claims under the terms of the bonds which, as of December 31, 2013, amounted to approximately US$1.6 billion.

3 The total assets realized on the sale of Nortel assets worldwide which are the subject of the allocation proceedings amongst the Canadian, US, and European, Middle East and African estates ("EMEA") are approximately US$7.3 billion, and thus the post-filing bond interest claims of now more than US$1.6 billion represent a substantial portion of the total assets available to all three estates. While the post-filing bond interest grows at various compounded rates under the terms of the bonds, the US$7.3 billion is apparently not growing at any appreciable rate because of the very conservative nature of the investments made with it pending the outcome of the insolvency proceedings. Apart from the bondholders, the main claimants against the Canadian debtors are Nortel disabled employees, former employees and retirees.

4 The bond claims in the Canadian proceedings have been filed pursuant to a claims procedure order in the CCAA proceedings dated July 30, 2009. The order contemplated that the claims filed under it would be finally determined in accordance with further procedures to be authorized, including by a further claims resolution order. By order dated September 16, 2010 [2010 CarswellOnt 8773 (S.C.C.)], a further order was made in the CCAA proceedings that authorized procedures to determine claims for all purposes.

5 By direction of June 24, 2014, it was ordered that the following issues be argued:

> (a) whether the holders of the crossover bond claims are legally entitled in each jurisdiction to claim or receive any amounts under the relevant indentures above and beyond the outstanding principal debt and pre-petition interest (namely, above and beyond US$4.092 billion); and
>
> (b) if it is determined that the crossover bondholders are so entitled, what additional amounts are such holders entitled to so claim and receive.

6 The hearing in the US Bankruptcy Court was scheduled to proceed at the same time as the hearing in this Court but was adjourned due to an apparent settlement between the US Debtors and the US Unsecured Creditors Committee.

7 The Monitor and Canadian debtors, supported by the Canadian Creditors' Committee, the UK Pension Claimants, the EMEA debtors, and the Wilmington Trust take the position that in a liquidating CCAA proceeding such as this, post-filing interest is not legally payable on the crossover bonds as a result of the "interest stops" rule. The Ad Hoc Group of Bondholders, supported by the US Unsecured Creditors' Committee, Law Debenture Trust Company of New York and Bank of New York Mellon take the position that there is no "interest stops" rule in CCAA proceedings and that the right to interest on the crossover bonds is not lost on the filing of CCAA proceedings and can be the subject of negotiations regarding a CCAA plan of reorganization. They take the position that no distribution of Nortel's sale proceeds that fails to recognize the full amount of the crossover bondholders' claims, including post-filing interest, can be ordered under the CCAA except under a negotiated CCAA plan duly approved by the requisite majorities of creditors and sanctioned by the court.

8 For the reasons that follow, I accept the position and hold that post-filing interest is not legally payable on the crossover bonds in this case.

**The interest stops rule**

9 In this case, the bondholders have a contractual right to interest. The other major claimants, being pensioners, do not. The Canadian debtors contend that the reason for the interest stops rule is one of fundamental fairness and that the rule should apply in this case.

10 The Canadian debtors contend that the interest-stops rule is a common law rule corollary to the *pari passu* rule governing rateable payments of an insolvent's debts and that while the CCAA is silent as to the right to post-filing interest, it does not rule out the interest-stops rule.

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11 The bondholders contend that to deny them the right to post-filing interest would amount to a confiscation of a property right to interest and that absent express statutory authority the court has no ability to interfere with their contractual entitlement to interest. I do not see their claim to interest as being a property right, as the bonds are unsecured. See *Thibodeau v. Thibodeau* (2011), 104 O.R. (3d) 161 (Ont. C.A.), at para. 43. However, the question remains as to whether their contractual rights should prevail.

12 It is a fundamental tenet of insolvency law that all debts shall be paid *pari passu* and all unsecured creditors receive equal treatment. See *Shoppers Trust Co. (Liquidator of) v. Shoppers Trust Co.* (2005), 74 O.R. (3d) 652 (Ont. C.A.) at para. 25, per Blair J.A. and *Indalex Ltd., Re* (2009), 55 C.B.R. (5th) 64 (Ont. S.C.J. [Commercial List]), at para. 16 per Morawetz J. This common law principle has led to the development of the interest stops rule. In *Canada (Attorney General) v. Confederation Life Insurance Co.*, [2001] O.J. No. 2610 (Ont. S.C.J. [Commercial List]), Blair J. (as he then was) stated the following:

> **20** One of the governing principles of insolvency law - including proceedings in a winding-up - is that the assets of the insolvent debtor are to be distributed amongst classes of creditors rateably and equally, as those assets are found at the date of the insolvency. This principle has led to the development of the "interest stops rule", i.e., that no interest is payable on a debt from the date of the winding-up or bankruptcy. As Lord Justice James put it, colourfully, in *Re Savin* (1872), L.R. 7 Ch. 760 (C.A.), at p. 764:
>
> > I believe, however, that if the question now arose for the first time I should agree with the rule [i.e. the "interest stops rule"], seeing that the theory in bankruptcy is to stop all things at the date of the bankruptcy, and to divide the wreck of the man's property as it stood at that time.

13 This rule is "judge-made" law. See *Humber Ironworks & Shipbuilding Co., Re* (1869), 4 Ch. App. 643 (Eng. Ch. Div.), at 647, per Sir G. M. Giffard, L.J.

14 In *Shoppers Trust*, Blair J.A. referred to *pari passu* principles in the context of the interest stops rule and the common law understanding of those rules in liquidation proceedings. He stated:

> 25. The rationale underlying this approach rests on a fundamental principle of insolvency law, namely, that "in the case of an insolvent estate, all the money being realized as speedily as possible, should be applied equally and rateably in payment of the debts as they existed at the date of the winding-up": *Humber Ironworks*, *supra*, at p. 646 Ch. App. Unless this is the case, the principle of *pari passu* distribution cannot be honoured. See also *Re McDougall*, [1883] O.J. No. 63, 8 O.A.R. 309, at paras. 13-15; *Principal Savings & Trust Co. v. Principal Group Ltd. (Trustee of)* (1993), 109 D.L.R. (4th) 390, 14 Alta. L.R. (3d) 442 (C.A.), at paras. 12-16; and *Canada (Attorney General) v. Confederation Trust Co.* (2003), 65 O.R. (3d) 519, [2003] O.J. No. 2754 (S.C.J.), at p. 525 [O.R.] While these cases were decided in the context of what is known as the "interest stops" rule, they are all premised on the common law understanding that claims for principal and interest are provable in liquidation proceedings to the date of the winding-up.

15 The interest stops rule has been applied in winding-up cases in spite of the fact that the legislation did not provide for it. In *Shoppers Trust*, Blair J.A. stated:

> 26. Thus, it was of little moment that the provisions of the *Winding-up Act* in force at the time of the March 10, 1993 order did not contain any such term. The 1996 amendment to s. 71(1) of the *Winding-up and Restructuring Act*, establishing that claims against the insolvent estate are to be calculated as at the date of the winding-up, merely clarified and codified the position as it already existed in insolvency law.

16 In *Abacus Cities Ltd. (Trustee of) v. AMIC Mortgage Investment Corp.* (1992), 11 C.B.R. (3d) 193 (Alta. C.A.), Kerans J.A. applied the interest stops rule in a bankruptcy proceeding under the BIA even although, in his view, the BIA assumed that interest was not payable after bankruptcy but did not expressly forbid it. He did so on the basis of the common law rule enunciated in *Savin, Re* [(1872), 7 Ch. App. 760 (Eng. Ch. Div.)], quoted by Blair J. in *Confederation Life*. Kerans J.A. stated:

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> 19. ... I accept that *Savin* expresses the law in Canada today: claims provable in bankruptcy cannot include interest after bankruptcy.

17 In *Confederation Life*, Blair J. was of the view that the Winding-Up Act and the BIA could be interpreted to permit post-filing interest. Yet he held that the common law insolvency interest stops rule applied. He stated:

> **22** This common law principle has been applied consistently in Canadian bankruptcy and winding-up proceedings. This is so notwithstanding the language of subsection 71(1) of the Winding-Up Act and section 121 of the BIA, which might be read to the contrary, in my view....
>
> **23** Yet the "interest stops" principle has always applied to the payment of post-insolvency interest, and the provisions of subsection 71(1) have never been interpreted to trump the common law insolvency "interest stops rule".

18 Thus I see no reason to not apply the interest stops rule to a CCAA proceeding because the CCAA does not expressly provide for its application. The issue is whether the rule should apply to this CCAA proceeding.

**Nature of the CCAA proceeding**

19 When the Nortel entities filed for CCAA protection on January 14, 2009, and filed on the same date in the US and the UK, the stated purpose was to stabilize the Nortel business to maximize the chances of preserving all or a portion of the enterprise. However that hope quickly evaporated and on June 19, 2009 Nortel issued a news release announcing it had sold its CMDA business and LTE Access assets and that it was pursuing the sale of its other business interests. Liquidation followed, first by a sale of Nortel's eight business lines in 2009-2011 for US$2.8 billion and second by the sale of its residual patent portfolio under a stalking-horse bid process in June 2011 for US$4.5 billion. The sale of the CMDA and LTE assets was approved on June 29, 2009.

20 The Canadian debtors contend that this CCAA proceeding is a liquidating proceeding, and thus in substance the same as a bankruptcy under the BIA. The bondholders contend that there is no definition of a "liquidating" CCAA proceeding and no distinct legal category of a liquidating CCAA, essentially arguing that like beauty, it is in the eyes of the beholder.

21 In this case, I think there is little doubt that this is a liquidating CCAA process and has been since June, 2009, notwithstanding that there was some consideration given to monetizing the residual intellectual property in a new company to be formed (referred to as IPCO) before it was decided to sell the residual intellectual property that resulted in the sale to the Rockstar consortium for US$4.5 billion. In *Nortel Networks Corp., Re*, 2012 ONSC 1213, 88 C.B.R. (5th) 111 (Ont. S.C.J. [Commercial List]), Morawetz J. referred to his recognizing in his June 29, 2009 Nortel decision approving the sale of the CMDA and LTE assets that the CCAA can be applied in "a liquidating insolvency". See also Dr. Janis P. Sarra, *Rescue! The Companies' Creditors Arrangement Act*, 2nd ed. (Toronto: Carswell, 2013) at p. 167, in which she states "increasingly, there are 'liquidating CCAA' proceedings, whereby the debtor corporation is for all intents and purposes liquidated".

22 In *Lehndorff General Partner Ltd., Re* (1993), 17 C.B.R. (3d) 24 (Ont. Gen. Div. [Commercial List]), Farley J. recognized in para. 7 that a CCAA proceeding might involve liquidation. He stated:

> It appears to me that the purpose of the CCAA is also to protect the interests of creditors and to enable an orderly distribution of the debtor company's affairs. This may involve a winding-up or liquidation of a company ... provided the same is proposed in the best interests of the creditors generally.

23 It is quite common now for there to be liquidating CCAA proceedings in which there is no successful restructuring of the business but rather a sale of the assets and a distribution of the proceeds to the creditors of the business. Nortel is unfortunately one of such CCAA proceedings.

**Can the interest stops rule apply in a CCAA proceeding?**

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24 There is no controlling authority in Canada in a case such as this in which there is a contested claim being made by bondholders for post-filing interest against an insolvent estate under the CCAA, let alone under a liquidating CCAA process, or in which the other creditors are mainly pensioners with no contractual right to post-filing interest. Accordingly, it is necessary to deal with first principles and with various cases raised by the parties.

25 The Canadian debtors contend that the rationale for the interest stops rule is equally applicable to a liquidating CCAA proceeding as it is in a BIA or Winding-Up proceeding. They assert that the reason for the interest stops rule is one of fundamental fairness. An insolvency filing under the CCAA stays creditor enforcement. Accordingly, it is unfair to permit the bondholders with a contractual right to receive a payment on account of interest, and thus compensation for the delay in receipt of payment, while other creditors such as the pension claimants, who have been equally delayed in payment by virtue of the insolvency, receive no compensation. They cite Sir G. M. Giffard, L.J. in *Humber Ironworks*:

> I do not see with what justice interest can be computed in favour of creditors whose debts carry interest, while creditors whose debts do not carry interest are stayed from recovering judgment, and so obtaining a right to interest.

26 In *Ted Leroy Trucking Ltd., Re*, 2010 SCC 60, [2010] 3 S.C.R. 379 (S.C.C.) [hereinafter Century Services], Deschamps J. reaffirmed that the purpose of a CCAA stay of proceedings is to preserve the *status quo*. She stated at para. 77:

> The *CCAA* creates conditions for preserving the *status quo* while attempts are made to find common ground amongst stakeholders for a reorganization that is fair to all.

27 If post-filing interest is available to one set of creditors while the other creditors are prevented from asserting their rights and obtaining post-judgment interest, the Canadian Creditors' Committee contend that the *status quo* has not been preserved.

28 It has long been recognized that the federal insolvency regime includes the CCAA and the BIA and that the two statutes create a complimentary and interrelated scheme for dealing dealing with the property of insolvent companies. See *Ivaco Inc., Re* (2006), 83 O.R. (3d) 108 (Ont. C.A.), at paras. 62 and 64, per Laskin J.A.

29 Recently the Supreme Court of Canada analysed the CCAA and indicated that the BIA and CCAA are to be considered parts of an integrated insolvency scheme, the court will favour interpretations that give creditors analogous entitlements under the CCAA and BIA, and the court will avoid interpretations that give creditors incentives to prefer BIA processes.

30 In *Century Services*, Deschamps J. enunciated guiding principles for interpreting the CCAA. Deschamps J. also stated that the case was the first time that the Supreme Court was called upon to directly interpret the provisions of the CCAA. The case involved competing interpretations of the federal *Excise Tax Act* ("ETA") and the CCAA in considering a deemed trust for GST collections. The ETA expressly excluded the provisions in the BIA rendering deemed trusts ineffective, but did not exclude similar provisions in the CCAA. In holding in favour of a stay under the CCAA, Deschamps J. was guided in her interpretation of the relevant CCAA provision by the desire to have similar results under the BIA and CCAA.

31 In her analysis, Deschamps J. made a number of statements, including

> Because the CCAA is silent about what happens if reorganization fails, the *BIA* scheme of liquidation and distribution necessarily supplies the backdrop for what will happen if a CCAA reorganization is ultimately unsuccessful. (para. 23)
>
> With parallel CCAA and BIA restructuring schemes now an accepted feature of the insolvency law landscape, the contemporary thrust of legislative reform has been towards harmonizing aspects of insolvency law common to the two statutory schemes to the extent possible and encouraging reorganization over liquidation. (para. 24)
>
> Moreover, a strange asymmetry would arise if the interpretation giving the ETA priority over the CCAA urged by the Crown is adopted here: the Crown would retain priority over GST claims during CCAA proceedings but not in bankruptcy. As courts have reflected, this can only encourage statute shopping by secured creditors in cases such as this one where the debtor's assets cannot satisfy both the secured creditors' and the Crown's claims (*Gauntlet*, at para. 21). If creditors'

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> claims were better protected by liquidation under the BIA, creditors' incentives would lie overwhelmingly with avoiding proceedings under the CCAA and not risking a failed reorganization. Giving a key player in any insolvency such skewed incentives against reorganizing under the CCAA can only undermine that statute's remedial objectives and risk inviting the very social ills that it was enacted to avert. (para. 47)
>
> Notably, acting consistently with its goal of treating both the BIA and the CCAA as sharing the same approach to insolvency, Parliament made parallel amendments to both statutes... (para. 54)
>
> The CCAA and BIA are related and no gap exists between the two statutes which would allow the enforcement of property interests at the conclusion of CCAA proceedings that would be lost in bankruptcy. (para. 78)

32 In *Indalex Ltd., Re*, [2013] 1 S.C.R. 271 (S.C.C.), a case involving a competition between a deemed trust under provincial pension legislation and the right of a lender to security granted under the DIP lending provisions of the CCAA, Deschamps J. had occasion to refer to the *Century Services* case and her statement in *Century Services* in para 23 referred to above. She then stated:

> In order to avoid a race to liquidation under the BIA, courts will favour an interpretation of the CCAA that affords creditors analogous entitlements.

33 Thus it is a fair comment taken the direction of the Supreme Court in *Century Services* and *Indalex* regarding the aims of insolvency law in Canada to say that if the common law principle of the interest stops rule was applicable to proceedings under the BIA and *Winding-Up Act* before legislative amendments to those statutes were made, (or if the comments of Blair J. in *Confederation Life* are accepted that the BIA still might be read to prevent its application but does not trump the application of the rule), there is no reason not to apply the interest stops rule in liquidating CCAA proceedings. I accept this and note that there is no provision in the CCAA that would not permit the application of the rule.

34 There are also policy reasons for this result, and they flow from *Century Services* and *Indalex*. I accept the argument of the Canadian Creditors' Committee that to permit some creditors' claims to grow disproportionately to others during the stay period would not maintain the *status quo* and would encourage creditors whose interests are being disadvantaged to immediately initiate bankruptcy proceedings, threatening the objectives of the CCAA.

35 In my view, there is no need for there to be a "liquidating" CCCAA proceeding in order for the interest stops rule to apply to a CCAA proceeding. The reasoning for the application of the common law insolvency rule, being the desire to prevent a stay of proceedings from militating against one group of unsecured creditors over another in violation of the *pari passu* rule, is equally applicable to a CCAA proceeding that is not a liquidating proceeding. In such a proceeding, the parties would of course be free to include post-filing interest payments in a plan of arrangement, as is sometimes done.

36 The bondholders contend, however, that *Stelco Inc., Re*, 2007 ONCA 483, 32 B.L.R. (4th) 77 (Ont. C.A.) is binding authority that the interest stops rule does not apply in any CCAA proceeding. I do not agree. The facts of the case were quite different and did not involve a claim for post-filing interest against the debtor. Stelco was successfully restructured under the CCAA by a plan of compromise and arrangement approved by the creditors. The sanctioned plan did not provide for payment of post-petition interest. As among senior unsecured debenture holders, subordinated (junior) debenture holders and ordinary unsecured creditors, the plan treated all in the same class and *pro rata* distributions were calculated on the basis that no post-filing interest was allowed. That result was not challenged.

37 The relevant pre-filing indenture in *Stelco* provided that in the event of any insolvency, the holders of all senior debt would first be entitled to receive payment in full of the principal and interest due thereon, before the junior debenture holders would be entitled to receive any payment or distribution of any kind which might otherwise be payable in respect of their debentures. While the plan cancelled all Stelco debentures, subject to section 6.01(2) of the plan, that section provided that the rights between the debenture holders were preserved. The plan was agreed to by the junior debenture holders. After the plan had been sanctioned, the junior debenture holders challenged the senior debt holders' right to receive the subordinated payments towards their outstanding interest.

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38 Wilton-Siegel J. rejected the argument, holding that the subordination agreement continued to operate independently of the sanctioned plan and was not affected by it. While it is not clear why, the junior Noteholders contended that interest stopped accruing in respect of the claims of the senior debenture holders against Stelco after the CCAA filing. There was no issue about a claim against Stelco for post-filing interest, as no such claim had ever been made. The issue was a contest between the two levels of debenture holders. However, Wilton-Siegel J. stated that in situations in which there was value to the equity, a CCAA plan could include post-filing interest. I take this statement to be *obiter*, but in any event, it is not the situation in Nortel as there is no equity at all. At the Court of Appeal, O'Connor A.C.J.O, Goudge and Blair JJ.A. agreed that the interest stops rule did not preclude the continuation of interest to the senior note holders from the subordinated payments to be made by the junior note holders under the binding inter-creditor arrangements.

39 In the course of its reasons, the Court of Appeal stated that there was no persuasive authority that supports an interest stops rule in a CCAA proceeding, and referred to statements of Binnie J. in *NAV Canada c. Wilmington Trust Co.*, 2006 SCC 24, [2006] 1 S.C.R. 865 (S.C.C.), [*NAV Canada*]. A number of comments can be made.

40 First, *Stelco* did not involve proceeding or claims against the debtor for post-filing interest. Second, the decision in *Stelco* was derived from the terms of negotiated inter-creditor agreements in the note indenture that were protected by plan. There was nothing about the common law interest stops rule that precluded one creditor from being held to its agreement to subordinate its realization to that of another creditor including foregoing its right to payment until the creditor with priority received principal and interest. That is what the Court of Appeal concluded by stating "We do not accept that there is a 'Interest Stops Rule' that precludes such a result". Third, the general statements made in *Stelco* and *NAV Canada* must now be considered in light of the later direction in *Century Services* and *Indalex*. I now turn to *NAV Canada*.

41 In *NAV Canada*, Canada 3000 Airlines filed for protection under the CCAA. Three days later the Monitor filed an assignment in bankruptcy on its behalf. Federal legislation gave the airport authorities a right to apply to the court authorizing the seizure of aircraft for outstanding payments owed by an airline for using an airport. The contest in the case was between the airport authorities and the owners/lessors of the aircraft as to the extent that the owners/lessors were liable for those payments and whether a seizure order could be made against the aircraft leased to the airline. It was ultimately held that the owners/lessors were not liable for the outstanding payments owed by the airline but that the aircraft could be seized.

42 Interest on the arrears was raised in the first instance before Ground J. He held that the airport authorities were entitled as against the bankrupt airline to detain the aircraft until all amounts with interest were paid in full or security for such payment was posted under the provisions of the legislation, i.e. interest continued to accrue and be payable after bankruptcy. The Court of Appeal did not deal with interest as in their view it was relevant only if the airport authorities had a claim against the owners/ lessors of the aircraft, which the court held they did not.

43 In the Supreme Court, which also dealt with an appeal from Quebec which dealt with the same issues, nearly the entire reasons of Binnie J. dealt with the issues as to whether the owners/lessors of the aircraft were liable for the outstanding charges and whether the aircraft could be seized by the airport authorities. It was held that the owners/lessors were not directly liable for the charges owed by the airline but that the aircraft could be seized until the charges were paid.

44 At the end of his reasons, Binnie J. dealt with interest and held that it continued to run until the earlier of payment, the posting of security, or bankruptcy. The bondholders rely on the last two sentences of the following paragraph from the reasons of Binnie J. which refer to the running of interest under the CCAA:

> **96** Given the authority to charge interest, my view is that interest continues to run to the first of the date of payment, the posting of security or bankruptcy. If interest were to stop accruing before payment has been made, then the airport authorities and NAV Canada would not recover the full amount owed to them in real terms. Once the owner, operator or titleholder has provided security, the interest stops accruing. The legal titleholder is then incurring the cost of the security and losing the time value of money. It should not have to pay twice. While a *CCAA* filing does not stop the accrual of

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interest, the unpaid charges remain an unsecured claim provable against the bankrupt airline. The claim does not accrue interest after the bankruptcy: ss. 121 and 122 of the *Bankruptcy and Insolvency Act*.

45 The Quebec airline in question had first filed to make a proposal under the BIA and when that proposal was rejected by its creditors, it was deemed to have made an assignment in bankruptcy as of the date its proposal was filed. Thus the comments of Binnie J. regarding the CCAA could not have related to the Quebec airline, but only to Canada 3000, which had been under the CCAA for only three days before it was assigned into bankruptcy. It is by no means clear how much effort, if any, was spent in argument on the three days' interest issue. Binnie J. did not refer to any argument on the point.

46 There was no discussion of the common law interest stops rule and whether it could apply during the three day period in question or whether it should apply to a liquidating CCAA proceeding. Nor was there any discussion of the definition of claim in the CCAA, being a claim provable within the meaning of the BIA, and how that might impact a claim for post-filing interest under the CCAA. The statement regarding interest under the CCAA was simply conclusory. It may be fair to say that the statement of Binnie J. was *per incuriam*.

47 In my view, the statement of Binnie J. should not be taken as a blanket statement that interest always accrues in a CCAA proceeding, regardless of whether or not it is a liquidating proceeding. The circumstances in *NAV Canada* were far different from Nortel involving several years of compound interest in excess of US$1.6 billion out of a total world-wide asset base of US$7.3 billion. The statement of Binnie J. should now be construed in light of *Century Services* and *Indalex*.

**Need for a CCAA plan**

48 The bondholders contend that there is no authority under the CCAA to effect a distribution of a debtor's assets absent a plan of arrangement or compromise that must be negotiated by the debtor with its creditors, and that as a plan can include payment of post-filing interest, it is not possible for a court to conclude that the bondholders have no right to post-filing interest. They assert that there is no jurisdiction for a court to compromise a creditor's claim in a CCAA proceeding except in the context of approving a plan approved by the creditors. They also assert that plan negotiations cannot meaningfully take place "in earnest" until the allocation decision as to how much of the US$7.3 billion is to be allocated to each of the Canadian, US, or EMEA estates.

49 One may ask what is left over in this case to negotiate. The assets have long been sold and what is left is to determine the claims against the Canadian estate and, once the amount of the assets in the Canadian estate are known, distribute the assets on a *pari passu* basis. This is not a case in which equity is exchanged for debt in a reorganization of a business such as *Stelco*.

50 However, even if there were things to negotiate, they would involve creditors compromising some right, and bargaining against those rights. What those rights are need to be determined, and often are in CCAA proceedings.

51 In this case, compensation claims procedure orders were made by Morawetz J. The order covering claims by bondholders is dated July 30, 2009. It was made without any objection by the bondholders. That order provides for a claim to be proven for the purposes of voting and distribution under a plan. The claims resolution order of Morawetz J. dated September 16, 2010 provides for a proven claim to be for all purposes, including for the purposes of voting and distribution under any plan. The determination now regarding the bondholders claim for post-filing interest is consistent with the process of determining whether these claims by the bondholders are finally proven. Contrary to the contention of the bondholders, it is not a process in which the court is being asked to compromise the bondholders' claim for post-filing interest. It is rather a determination of whether they have a right to such interest.

52 It is perhaps not necessary to determine at this stage how the assets will be distributed and whether a plan, or what type of plan, will be necessary. However, in light of the argument advanced on behalf of the bondholders, I will deal with this issue.

53 I first note that the CCAA makes no provision as to how money is to be distributed to creditors. This is not surprising taken that plans of reorganization do not necessarily provide for payments to creditors and taken that the CCAA does not expressly provide for a liquidating CCAA process. There is no provision that requires distributions to be made under a plan of arrangement.

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54 A court has wide powers in a CCAA proceeding to do what is just in the circumstances. Section 11(1) provides that a court may make any order it considers appropriate in the circumstances. Although this section was provided by an amendment that came into force after Nortel filed under the CCAA, and therefore by the amendment the new section does not apply to Nortel, it has been held that the provision merely reflects past jurisdiction. In *Century Services*, Deschamps J. stated:

> **65** I agree with Justice Georgina R. Jackson and Professor Janis Sarra that the most appropriate approach is a hierarchical one in which courts rely first on an interpretation of the provisions of the *CCAA* text before turning to inherent or equitable jurisdiction to anchor measures taken in a *CCAA* proceeding (see G. R. Jackson and J. Sarra, "Selecting the Judicial Tool to get the Job Done: An Examination of Statutory Interpretation, Discretionary Power and Inherent Jurisdiction in Insolvency Matters", in J. P. Sarra, ed., *Annual Review of Insolvency Law 2007* (2008), 41, at p. 42). The authors conclude that when given an appropriately purposive and liberal interpretation, the *CCAA* will be sufficient in most instances to ground measures necessary to achieve its objectives (p. 94).
>
> **67** The initial grant of authority under the *CCAA* empowered a court "where an application is made under this Act in respect of a company ... on the application of any person interested in the matter ..., subject to this Act, [to] make an order under this section" (*CCAA*, s. 11(1)). The plain language of the statute was very broad.
>
> **68** In this regard, though not strictly applicable to the case at bar, I note that Parliament has in recent amendments changed the wording contained in s. 11(1), making explicit the discretionary authority of the court under the *CCAA*. Thus in s. 11 of the *CCAA* as currently enacted, a court may, "subject to the restrictions set out in this Act, ... make any order that it considers appropriate in the circumstances" (S.C. 2005, c. 47, s. 128). Parliament appears to have endorsed the broad reading of *CCAA* authority developed by the jurisprudence.
>
> (underlining added)

55 I note also that payments to creditors without plans of arrangement or compromises are often ordered. In *Timminco Ltd., Re*, 2014 ONSC 3393 (Ont. S.C.J.), Morawetz J. noted at para. 38 that the assets of Timminco had been sold and distributions made to secured creditors without any plan and with no intention to advance a plan. In that case, there was a shortfall to the secured creditors and no assets available to the unsecured creditors. The fact that the distributions went to the secured creditors rather than to an unsecured creditor makes no difference to the jurisdiction under the CCAA to do so.

56 In *AbitibiBowater Inc., Re*, 2009 QCCS 6461 (C.S. Que.), Gascon J.C.S. (as he then was) granted a large interim distribution from the proceeds of a sale transaction to senior secured noteholders ("SSNs"). The bondholders opposed the distribution on the same grounds as advanced by the bondholders in this case:

> 56 The Bondholders claim that the proposed distribution violates the CCAA. From their perspective, nothing in the statute authorizes a distribution of cash to a creditor group prior to approval of a plan of arrangement by the requisite majorities of creditors and the Court. They maintain that the SSNs are subject to the stay of proceedings like all other creditors.
>
> 57 By proposing a distribution to one class of creditors, the Bondholders contend that the other classes of creditors are denied the ability to negotiate a compromise with the SSNs. Instead of bringing forward their proposed plan and creating options for the creditors for negotiation and voting purposes, the Abitibi Petitioners are thus eliminating bargaining options and confiscating the other creditors' leverage and voting rights.
>
> 58 Accordingly, the Bondholders conclude that the proposed distribution should not be considered until after the creditors have had an opportunity to negotiate a plan of arrangement or a compromise with the SSNs.

57 Justice Gascon did not accept this argument. He stated:

> 71 Despite what the Bondholders argue, it is neither unusual nor unheard of to proceed with an interim distribution of net proceeds in the context of a sale of assets in a CCAA reorganization. Nothing in the CCAA prevents similar interim

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> distribution of monies. There are several examples of such distributions having been authorized by Courts in Canada. (underlining added)

58 Justice Gascon was persuaded that the distribution should be made as it was part and parcel of a DIP loan arrangement that he approved. Whatever the particular circumstances were that led to the exercise of his discretion, he did not question that he had jurisdiction to make an order distributing proceeds without a plan of arrangement. I see no difference between an interim distribution, as in the case of *AbitibiBowater*, or a final distribution, as in the case of *Timminco*, or a distribution to an unsecured or secured creditor, so far as a jurisdiction to make the order is concerned without any plan of arrangement.

59 There is a comment by Laskin J.A. in *Ivaco Inc., Re* (2006), 83 O.R. (3d) 108 (Ont. C.A.) that questions the right of a judge to order payment out of funds realized on the sale of assets under a CCAA process, in that case to pension plan administrators for funding deficiencies. He stated:

> [I]n my view, absent an agreement, I doubt that the CCAA even authorized the motions judge to order this payment. Once restructuring was not possible and the CCAA proceedings were spent, as the motions judge found and all parties acknowledged, I question whether the court had any authority to order a distribution of the sale proceeds.

60 This was an *obiter* statement. But in any event Justice Laskin was discussing a situation in which all parties agreed that the CCAA proceedings "were spent". That is, there was effectively no CCAA proceeding any more. This is not the situation with Nortel and I do not see the *obiter* statement as being applicable. As stated by Justice Gascon, distribution orders without a plan are common in Canada.

61 While it need not be decided, I am not persuaded that it would not be possible for a court to make an order distributing the proceeds of the Nortel sale without a plan of arrangement or compromise.

**Conclusion**

62 I hold and declare that holders of the crossover bond claims are not legally entitled to claim or receive any amounts under the relevant indentures above and beyond the outstanding principal debt and pre-petition interest (namely, above and beyond US$4.092 billion).

63 Those seeking costs may make cost submissions in writing within 10 days and responding submissions may be made in writing within a further 10 days. Submissions are to be brief and include a proper cost outline for costs sought.

*Order accordingly.*

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# TAB 21

**BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION, PETITIONER v. 203 NORTH LASALLE STREET PARTNERSHIP**

**No. 97-1418**

**SUPREME COURT OF THE UNITED STATES**

**526 U.S. 434; 119 S. Ct. 1411; 143 L. Ed. 2d 607; 1999 U.S. LEXIS 3003; 67 U.S.L.W. 4275; Bankr. L. Rep. (CCH) P77,924; 41 Collier Bankr. Cas. 2d (MB) 526; 34 Bankr. Ct. Dec. 329; 99 Cal. Daily Op. Service 3158; 99 Daily Journal DAR 4133; 1999 Colo. J. C.A.R. 2439; 13 Tex. Bankr. Ct. Rep. 169; 12 Fla. L. Weekly Fed. S 216**

**November 2, 1998, Argued**
**May 3, 1999, Decided**

**PRIOR HISTORY:** ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

**DISPOSITION:** 126 F.3d 955, reversed and remanded.

**COUNSEL:** Roy T. Englert, Jr. argued the cause for petitioner.

Patricia A. Millett argued the cause for the United States, as amicus curiae, by special leave of court.

Richard M. Bendix, Jr. argued the cause for respondent.

**JUDGES:** SOUTER, J., delivered the opinion of the Court, in which REHNQUIST, C. J., and O'CONNOR, KENNEDY, GINSBURG, and BREYER, JJ., joined. THOMAS, J., filed an opinion concurring in the judgment, in which SCALIA, J., joined. STEVENS, J., filed a dissenting opinion.

**OPINION BY:** SOUTER

**OPINION**

**[*437] [**1414] [***612]** JUSTICE SOUTER delivered the opinion of the Court.

**[***LEdHR1A]** [1A]The issue in this Chapter 11 reorganization case is whether a debtor's prebankruptcy equity holders may, over the objection of a senior class of impaired creditors, contribute new capital and receive ownership interests in the reorganized **[***613]** entity, when that opportunity is given exclusively to the old equity holders under a plan adopted without consideration of alternatives. We hold that old equity holders are disqualified from participating in such a "new value" transaction by the terms of 11 U.S.C. § 1129(b)(2)(B)(ii), which in such circumstances bars a junior interest holder's receipt of any property on account of his prior interest.

I

Petitioner, Bank of America National Trust and Savings Association (Bank), [1] is the major creditor of respondent, 203 North LaSalle Street Partnership (Debtor or Partnership), **[*438]** an Illinois real estate limited partnership. [2] The Bank lent the Debtor some $ 93 million, secured by a nonrecourse first mortgage [3] on the Debtor's principal asset, 15 floors of an office building in downtown Chicago. In January 1995, the Debtor defaulted, and the Bank began foreclosure in a state court.

1 Bank of America, Illinois was the appellant in

the case below. As a result of a merger, it is now known as Bank of America National Trust and Savings Association.

2 The limited partners in this case are considered the Debtor's equity holders under the Bankruptcy Code, see 11 U.S.C. §§ 101(16), (17), and the Debtor Partnership's actions may be understood as taken on behalf of its equity holders.

3 A nonrecourse loan requires the Bank to look only to the Debtor's collateral for payment. But see n. 6, *infra*.

In March, the Debtor responded with a voluntary petition for relief under Chapter 11 of the Bankruptcy Code, 11 U.S.C. § 1101 *et seq*., which automatically stayed the foreclosure proceedings, see § 362(a). *In re 203 N. LaSalle Street Partnership,* 126 F.3d 955, 958 (CA7 1997); *Bank of America, Illinois* v. *203 N. LaSalle Street Partnership,* 195 B.R. 692, 696 (ND Ill. 1996). The Debtor's principal objective was to ensure that its partners retained title to the property so as to avoid roughly $ 20 million in personal tax liabilities, which would fall due if the Bank foreclosed. 126 F.3d at 958; 195 B.R. at 698. The Debtor proceeded to propose a reorganization plan during the 120-day period when it alone had the right to do so, see 11 U.S.C. § 1121(b); see also § 1121(c) (exclusivity period extends to 180 days if the debtor files plan within the initial 120 days). [4] The Bankruptcy Court rejected the Bank's motion to terminate the period of exclusivity to make way for a plan of its own to **[*439]** liquidate the property, and instead extended the exclusivity period for cause shown, under § 1121(d). [5]

4 The Debtor filed an initial plan on April 13, 1995, and amended it on May 12, 1995. The Bank objected, and the Bankruptcy Court rejected the plan on the ground that it was not feasible. See § 1129(a)(11). The Debtor submitted a new plan on September 11, 1995. *In re 203 N. LaSalle*, 126 F.3d 955, 958-959 (CA7 1997).

5 The Bank neither appealed the denial nor raised it as an issue in this appeal.

The value of the mortgaged property was less than the balance due the Bank, which elected to divide its undersecured claim into secured and unsecured deficiency claims under § 506(a) and § 1111(b). [6] 126 F.3d at 958. Under the plan, the Debtor **[***614]** separately classified the Bank's secured claim, its unsecured deficiency claim, and unsecured trade **[**1415]** debt owed to other creditors. See § 1122(a). [7] The Bankruptcy Court found that the Debtor's available assets were prepetition rents in a cash account of $ 3.1 million and the 15 floors of rental property worth $ 54.5 million. The secured claim was valued at the latter figure, leaving the Bank with an unsecured deficiency of $ 38.5 million.

6 Having agreed to waive recourse against any property of the Debtor other than the real estate, the Bank had no unsecured claim outside of Chapter 11. Section 1111(b), however, provides that nonrecourse secured creditors who are undersecured must be treated in Chapter 11 as if they had recourse.

7 Indeed, the Seventh Circuit apparently requires separate classification of the deficiency claim of an undersecured creditor from other general unsecured claims. See *In re Woodbrook Associates*, 19 F.3d 312, 319 (1994). Nonetheless, the Bank argued that if its deficiency claim had been included in the class of general unsecured creditors, its vote against confirmation would have resulted in the plan's rejection by that class. The Bankruptcy Court and the District Court rejected the contention that the classifications were gerrymandered to obtain requisite approval by a single class, *In re 203 N. LaSalle Street Limited Partnership,* 190 B.R. 567, 592-593 (Bkrtcy. Ct. ND Ill. 1995); *Bank of America, Illinois* v. *203 N. LaSalle Street Partnership,* 195 B.R. 692, 705 (ND Ill. 1996), and the Court of Appeals agreed, 126 F.3d at 968. The Bank sought no review of that issue, which is thus not before us.

So far as we need be concerned here, the Debtor's plan had these further features:

**[*440]** (1) The Bank's $ 54.5 million secured claim would be paid in full between 7 and 10 years after the original 1995 repayment date. [8]

8 Payment consisted of a prompt cash payment of $ 1,149,500 and a secured, 7-year note, extendable at the Debtor's option. 126 F.3d at 959, n. 4; 195 B.R. at 698.

(2) The Bank's $ 38.5 million unsecured deficiency claim would be discharged for an estimated 16% of its

present value. [9]

9 This expected yield was based upon the Bankruptcy Court's projection that a sale or refinancing of the property on the 10th anniversary of the plan confirmation would produce a $ 19-million distribution to the Bank.

(3) The remaining unsecured claims of $ 90,000, held by the outside trade creditors, would be paid in full, without interest, on the effective date of the plan. [10]

10 The Debtor originally owed $ 160,000 in unsecured trade debt. After filing for bankruptcy, the general partners purchased some of the trade claims. Upon confirmation, the insiders would waive all general unsecured claims they held. 126 F.3d at 958, n. 2; 195 B.R. at 698.

(4) Certain former partners of the Debtor would contribute $ 6.125 million in new capital over the course of five years (the contribution being worth some $ 4.1 million in present value), in exchange for the Partnership's entire ownership of the reorganized debtor.

The last condition was an exclusive eligibility provision: the old equity holders were the only ones who could contribute new capital. [11]

11 The plan eliminated the interests of noncontributing partners. More than 60% of the Partnership interests would change hands on confirmation of the plan. See Brief for Respondent 4, n. 7. The new Partnership, however, would consist solely of former partners, a feature critical to the preservation of the Partnership's tax shelter. Tr. of Oral Arg. 32.

The Bank objected and, being the sole member of an impaired class of creditors, thereby blocked confirmation **[***615]** of the **[*441]** plan on a consensual basis. See § 1129(a)(8). [12] The Debtor, however, took the alternate route to confirmation of a reorganization plan, forthrightly known as the judicial "cramdown" process for imposing a plan on a dissenting class. § 1129(b). See generally Klee, All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code, 53 Am. Bankr. L. J. 133 (1979).

12 A class of creditors accepts if a majority of the creditors and those holding two-thirds of the total dollar amount of the claims within that class vote to approve the plan. § 1126(c).

There are two conditions for a cramdown. First, all requirements of § 1129(a) must be met (save for the plan's acceptance by each impaired class of claims or interests, see § 1129(a)(8)). Critical among them are the conditions that the plan be accepted by at least one class of impaired creditors, see § 1129(a)(10), and satisfy the "best-interest-of-creditors" test, see § 1129(a)(7). [13] Here, **[**1416]** the class of trade creditors with impaired unsecured claims voted for the plan, [14] 126 F.3d at 959, and there was no issue of best interest. Second, the objection of an impaired creditor class may be overridden only if "the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." § 1129(b)(1). As to a dissenting class of impaired unsecured creditors, such a plan may be found to be "fair and equitable" only if the allowed value of the claim is to be paid in full, § 1129(b)(2)(B)(i), or, in the alternative, **[*442]** if "the holder of any claim or interest that is junior to the claims of such [impaired unsecured] class will not receive or retain under the plan on account of such junior claim or interest any property," § 1129(b)(2)(B)(ii). That latter condition is the core of what is known as the "absolute priority rule."

13 Section 1129(a)(7) provides that if the holder of a claim impaired under a plan of reorganization has not accepted the plan, then such holder must "receive . . . on account of such claim . . . property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive . . . if the debtor were liquidated under chapter 7 . . . on such date." The "best interests" test applies to individual creditors holding impaired claims, even if the class as a whole votes to accept the plan.

14 Claims are unimpaired if they retain all of their prepetition legal, equitable, and contractual rights against the debtor. § 1124.

The absolute priority rule was the basis for the Bank's position that the plan could not be confirmed as a cramdown. As the Bank read the rule, the plan was open to objection simply because certain old equity holders in the Debtor Partnership would receive property even though the Bank's unsecured deficiency claim would not be paid in full. The Bankruptcy Court approved the plan

nonetheless, and accordingly denied the Bank's pending motion to convert the case to Chapter 7 liquidation, or to dismiss the case. The District Court affirmed, 195 B.R. 692 (ND Ill. 1996), as did the Court of Appeals.

The majority of the Seventh Circuit's divided panel found ambiguity in the language of the statutory absolute priority rule, and looked beyond the text to interpret the phrase "on account of" as permitting recognition of a "new value corollary" to the rule. 126 F.3d at 964-965. According to the panel, the corollary, as stated by this Court in *Case* v. *Los Angeles* **[***616]** *Lumber Products Co.,* 308 U.S. 106, 118, 84 L. Ed. 110, 60 S. Ct. 1 (1939), provides that the objection of an impaired senior class does not bar junior claim holders from receiving or retaining property interests in the debtor after reorganization, if they contribute new capital in money or money's worth, reasonably equivalent to the property's value, and necessary for successful reorganization of the restructured enterprise. The panel majority held that

"when an old equity holder retains an equity interest in the reorganized debtor by meeting the requirements of the new value corollary, he is not receiving or retaining that interest 'on account of ' his prior equitable ownership **[*443]** of the debtor. Rather, he is allowed to participate in the reorganized entity 'on account of ' a new, substantial, necessary and fair infusion of capital." 126 F.3d at 964.

In the dissent's contrary view, there is nothing ambiguous about the text: the "plain language of the absolute priority rule . . . does not include a new value exception." 126 F.3d at 970 (opinion of Kanne, J.). Since "the Plan in this case gives [the Debtor's] partners the exclusive right to retain their ownership interest in the indebted property *because of* their status as . . . prior interest holders," 126 F.3d at 973, the dissent would have reversed confirmation of the plan.

We granted certiorari, 523 U.S. 1106 (1998), to resolve a Circuit split on the issue. The Seventh Circuit in this case joined the Ninth in relying on a new value corollary to the absolute priority rule to support confirmation of such plans. See *In re Bonner Mall Partnership*, 2 F.3d 899, 910-916 (CA9 1993), cert. granted, 510 U.S. 1039, vacatur denied and appeal dism'd as moot, 513 U.S. 18, 115 S. Ct. 386, 130 L. Ed. 2d 233 (1994). The Second and Fourth Circuits, by contrast, without explicitly rejecting the corollary, have disapproved plans similar to this one. See *In re Coltex Loop Central Three Partners, L. P.*, 138 F.3d 39, 44-45 (CA2 1998); *In re Bryson Properties, XVIII*, 961 F.2d 496, 504 (CA4), cert. denied, 506 U.S. 866, 121 L. Ed. 2d 134, 113 S. Ct. 191 **[**1417]** (1992). [15] We do not decide whether the statute includes a new value corollary or exception, but hold that on any reading respondent's proposed plan fails to satisfy the statute, and accordingly reverse.

15 All four of these cases arose in the single-asset real estate context, the typical one in which new value plans are proposed. See 7 Collier on Bankruptcy P1129.04[4][c][ii][B], p. 1129-113 (15th ed. rev. 1998). See also Strub, Competition, Bargaining, and Exclusivity under the New Value Rule: Applying the Single-Asset Paradigm of *Bonner Mall*, 111 Banking L. J. 228, 231 (1994) ("Most of the cases discussing the new value issue have done so in connection with an attempt by a single-asset debtor to reorganize under chapter 11").

**[*444]** II

The terms "absolute priority rule" and "new value corollary" (or "exception") are creatures of law antedating the current Bankruptcy Code, and to understand both those terms and the related but inexact language of the Code some history is helpful. The Bankruptcy Act preceding the Code contained no such provision as subsection (b)(2)(B)(ii), its subject having been addressed by two interpretive rules. The first was a specific gloss on the requirement of § 77B (and its successor, Chapter X) of the old Act, that any reorganization plan **[***617]** be "fair and equitable." 11 U.S.C. § 205(e) (1934 ed., Supp. I) (repealed 1938) ( § 77B); 11 U.S.C. § 621(2) (1934 ed., Supp. IV) (repealed 1979) (Chapter X). The reason for such a limitation was the danger inherent in any reorganization plan proposed by a debtor, then and now, that the plan will simply turn out to be too good a deal for the debtor's owners. See H. R. Doc. No. 93-137, pt. I, p. 255 (1973) (discussing concern with "the ability of a few insiders, whether representatives of management or major creditors, to use the reorganization process to gain an unfair advantage"); *ibid.* ("It was believed that creditors, because of management's position of dominance, were not able to bargain effectively without a clear standard of fairness and judicial control"); Ayer, Rethinking Absolute Priority After *Ahlers*, 87 Mich. L. Rev. 963, 969-973 (1989).

Hence the pre-Code judicial response known as the absolute priority rule, that fairness and equity required that "the creditors . . . be paid before the stockholders could retain [equity interests] for any purpose whatever." *Northern Pacific R. Co.* v. *Boyd,* 228 U.S. 482, 508, 57 L. Ed. 931, 33 S. Ct. 554 (1913). See also *Louisville Trust Co.* v. *Louisville, N. A. & C. R. Co.,* 174 U.S. 674, 684, 43 L. Ed. 1130, 19 S. Ct. 827 (1899) (reciting "the familiar rule that the stockholder's interest in the property is subordinate to the rights of creditors; first of secured and then of unsecured creditors" and concluding that "any arrangement of the parties by which the subordinate **[*445]** rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation").

The second interpretive rule addressed the first. Its classic formulation occurred in *Case* v. *Los Angeles Lumber Products Co.,* in which the Court spoke through Justice Douglas in this dictum:

"It is, of course, clear that there are circumstances under which stockholders may participate in a plan of reorganization of an insolvent debtor . . . . Where the necessity [for new capital] exists and the old stockholders make a fresh contribution and receive in return a participation reasonably equivalent to their contribution, no objection can be made . . . .

"We believe that to accord 'the creditor his full right of priority against the corporate assets' where the debtor is insolvent, the stockholder's participation must be based on a contribution in money or in money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder." 308 U.S. at 121-122.

Although counsel for one of the parties here has described the *Case* observation as "'black-letter' principle," Brief for Respondent 38, it never rose above the technical level of dictum in any opinion of this Court, which last addressed it in *Norwest Bank Worthington* v. *Ahlers,* 485 U.S. 197, 99 L. Ed. 2d 169, 108 S. Ct. 963 (1988), holding that a contribution of "'labor, experience, and expertise'" by a junior interest holder was not in the "'money's worth'" that the *Case* **[**1418]** observation required. 485 U.S. at 203-205. **[***618]** See also *Marine Harbor Properties, Inc.* v. *Manufacturers Trust Co.,* 317 U.S. 78, 85, 87 L. Ed. 64, 63 S. Ct. 93 (1942); *Consolidated Rock Products Co.* v. *Du Bois,* 312 U.S. 510, 529, n. 27, 85 L. Ed. 982, 61 S. Ct. 675 (1941). Nor, prior to the enactment of the current Bankruptcy Code, **[*446]** did any court rely on the *Case* dictum to approve a plan that gave old equity a property right after reorganization. See Ayer, *supra*, at 1016; Markell, Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations, 44 Stan. L. Rev. 69, 92 (1991). Hence the controversy over how weighty the *Case* dictum had become, as reflected in the alternative labels for the new value notion: some writers and courts (including this one, see *Ahlers*, *supra*, at 203, n. 3) have spoken of it as an exception to the absolute priority rule, see, *e.g.*, *In re Potter Material Service, Inc*., 781 F.2d 99, 101 (CA7 1986); Miller, Bankruptcy's New Value Exception: No Longer a Necessity, 77 B. U. L. Rev. 975 (1997); Georgakopoulos, New Value, Fresh Start, 3 Stan. J. L. Bus. & Fin. 125 (1997), while others have characterized it as a simple corollary to the rule, see, *e.g.*, *In re Bonner Mall Partnership*, 2 F.3d at 906; Ayer, *supra*, at 999.

Enactment of the Bankruptcy Code in place of the prior Act might have resolved the status of new value by a provision bearing its name or at least unmistakably couched in its terms, but the Congress chose not to avail itself of that opportunity. In 1973, Congress had considered proposals by the Bankruptcy Commission that included a recommendation to make the absolute priority rule more supple by allowing nonmonetary new value contributions. H. R. Doc. No. 93-137, pt. I, at 258-259; *id.,* pt. II, at 242, 252. Although Congress took no action on any of the ensuing bills containing language that would have enacted such an expanded new value concept, [16] each of them was reintroduced in the next congressional session. See H. R. 31, 94th Cong., 1st Sess., **[*447]** §§ 7-303(4), [17] 7-310(d)(2)(B) (1975); [18] H. R. 32, 94th Cong., 1st Sess., §§ 7-301(4), 7-308(d)(2)(B) (1975); S. 235, 94th Cong., 1st Sess., §§ 7-301(4), 7-308(d)(2)(B) (1975); S. 236, 94th Cong., 1st Sess., §§ 7-303(4), 7-310(d)(2)(B) (1975). After extensive hearings, a substantially revised House bill emerged, but without any provision for nonmonetary new value contributions. See H. R. 6, 95th Cong., 1st Sess., **[***619]** §§ 1123, 1129(b) (1977). [19] After a lengthy mark-up session, the House produced H. R. 8200, 95th Cong., 1st Sess. (1977), which would eventually become the law, H. R. Rep. No. 95-595, p. 3 (1977). It had no explicit new value language, expansive or otherwise, but did codify the absolute priority rule in nearly its present form. See H. R. 8200, *supra*, § 1129(b)(2)(B)(iv) ("The holders of claims or interests of any class of claims or

interests, **[**1419]** as the case may be, that is junior to such class will not receive or retain under **[*448]** the plan on account of such junior claims or interests any property"). [20]

16 See H. R. 10792, 93d Cong., 1st Sess., §§ 7-303(4), 7-310(d)(2)(B) (1973); H. R. 16643, 93d Cong., 2d Sess., §§ 7-301(4), 7-308(d)(2)(B) (1974); S. 2565, 93d Cong., 1st Sess., §§ 7-303(4), 7-310(d)(2)(B) (1973); S. 4046, 93d Cong., 2d Sess., §§ 7-301(4), 7-308(d)(2)(B) (1974).

17 Section 7-303(4) read: "When the equity security holders retain an interest under the plan, the individual debtor, certain partners or equity security holders will make a contribution which is important to the operation of the reorganized debtor or the successor under the plan, for participation by the individual debtor, such partners, or such holders under the plan on a basis which reasonably approximates the value, if any, of their interests, and the additional estimated value of such contribution."

18 Section 7-310(d)(2)(B) read: "Subject to the provisions of section 7-303 (3) and (4) and the court's making any findings required thereby, there is a reasonable basis for the valuation on which the plan is based and the plan is fair and equitable in that there is a reasonable probability that the securities issued and other consideration distributed under the plan will fully compensate the respective classes of creditors and equity security holders of the debtor for their respective interests in the debtor or his property."

19 Section 1129(b) of H. R. 6 read, in relevant part: "The court, on request of the proponent of such plan, shall confirm such plan . . . if such plan is fair and equitable with respect to all classes except any class that has accepted the plan and that is comprised of claims or interests on account of which the holders of such claims or interests will receive or retain under the plan not more than would be so received or retained under a plan that is fair and equitable with respect to all classes."

20 While the earlier proposed bills contained provisions requiring as a condition of confirmation that a plan be "fair and equitable," none of them contained language explicitly codifying the absolute priority rule. See, *e.g.*, nn. 17-19, *supra*.

For the purpose of plumbing the meaning of subsection (b)(2)(B)(ii) in search of a possible statutory new value exception, the lesson of this drafting history is equivocal. Although hornbook law has it that "'Congress does not intend *sub silentio* to enact statutory language that it has earlier discarded,'" *INS* v. *Cardoza-Fonseca,* 480 U.S. 421, 442-443, 94 L. Ed. 2d 434, 107 S. Ct. 1207 (1987), the phrase "on account of" is not *silentium*, and the language passed by in this instance had never been in the bill finally enacted, but only in predecessors that died on the vine. None of these contained an explicit codification of the absolute priority rule, [21] and even in these earlier bills the language in question stated an expansive new value concept, not the rule as limited in the *Case* dictum. [22]

21 See n. 20, *supra*.

22 See nn. 17-18, *supra*.

The equivocal note of this drafting history is amplified by another feature of the legislative advance toward the current law. Any argument from drafting history has to account for the fact that the Code does not codify any authoritative pre-Code version of the absolute priority rule. Compare § 1129(b)(2)(B)(ii) ("The holder of any claim or interest that is junior to the claims of such [impaired unsecured] class will not receive or retain under the plan on account of such junior claim or interest any property") with *Boyd,* 228 U.S. at 508 ("The creditors were entitled to be paid before the stockholders could retain [a right of property] for any purpose whatever"), and *Case,* 308 U.S. at 116 ("'Creditors are entitled to priority over stockholders against all the property of an insolvent corporation'" (quoting *Kansas City Terminal R. Co.* v. *Central Union* **[*449]** *Trust Co. of N. Y.,* 271 U.S. 445, 455, 70 L. Ed. 1028, 46 S. Ct. 549 (1926))). See H. R. Rep. No. 95-595, *supra,* at 414 (characterizing § 1129(b)(2)(B)(ii) as a "partial codification of the absolute priority rule"); *ibid.* ("The elements of the [fair and equitable] test are new[,] departing from both the absolute priority rule **[***620]** and the best interests of creditors tests found under the Bankruptcy Act").

The upshot is that this history does nothing to disparage the possibility apparent in the statutory text, that the absolute priority rule now on the books as subsection (b)(2)(B)(ii) may carry a new value corollary. Although there is no literal reference to "new value" in the phrase "on account of such junior claim," the phrase could arguably carry such an implication in modifying

the prohibition against receipt by junior claimants of any interest under a plan while a senior class of unconsenting creditors goes less than fully paid.

III

Three basic interpretations have been suggested for the "on account of" modifier. The first reading is proposed by the Partnership, that "on account of " harks back to accounting practice and means something like "in exchange for," or "in satisfaction of," Brief for Respondent 12-13, 15, n. 16. On this view, a plan would not violate the absolute priority rule unless the old equity holders received or retained property in exchange for the prior interest, without any significant new contribution; if substantial money passed from them as part of the deal, the prohibition of subsection (b)(2)(B)(ii) would not stand in the way, and whatever issues of fairness and equity there might otherwise be would not implicate the "on account of " modifier.

This position is beset with troubles, the first one being textual. Subsection (b)(2)(B)(ii) forbids not only receipt of property on account of the prior interest but its retention as well. See also §§ 1129(a)(7)(A)(ii), (a)(7)(B), (b)(2)(B)(i), **[**1420]** (b)(2)(C)(i), (b)(2)(C)(ii). A common instance of the latter **[*450]** would be a debtor's retention of an interest in the insolvent business reorganized under the plan. Yet it would be exceedingly odd to speak of "retaining" property in exchange for the same property interest, and the eccentricity of such a reading is underscored by the fact that elsewhere in the Code the drafters chose to use the very phrase "in exchange for," § 1123(a)(5)(J) (a plan shall provide adequate means for implementation, including "issuance of securities of the debtor . . . for cash, for property, for existing securities, or in exchange for claims or interests"). It is unlikely that the drafters of legislation so long and minutely contemplated as the 1978 Bankruptcy Code would have used two distinctly different forms of words for the same purpose. See *Russello* v. *United States*, 464 U.S. 16, 23, 78 L. Ed. 2d 17, 104 S. Ct. 296 (1983).

The second difficulty is practical: the unlikelihood that Congress meant to impose a condition as manipulable as subsection (b)(2)(B)(ii) would be if "on account of" meant to prohibit merely an exchange unaccompanied by a substantial infusion of new funds but permit one whenever substantial funds changed hands. "Substantial" or "significant" or "considerable" or like characterizations of a monetary contribution would measure it by the Lord Chancellor's foot, and an absolute priority rule so variable would not be much of an absolute. Of course it is true (as already noted) that, even if old equity holders could displace the rule by adding some significant amount of cash to the deal, it would not follow that their plan would be entitled **[***621]** to adoption; a contested plan would still need to satisfy the overriding condition of fairness and equity. But that general fairness and equity criterion would apply in any event, and one comes back to the question why Congress would have bothered to add a separate priority rule without a sharper edge.

**[***LEdHR1A]** [1B]Since the "in exchange for" reading merits rejection, the way is open to recognize the more common understanding of "on account of " to mean "because of." This is certainly the usage meant for the phrase at other places in the statute, **[*451]** see § 1111(b)(1)(A) (treating certain claims as if the holder of the claim "had recourse against the debtor on account of such claim"); § 522(d)(10)(E) (permitting debtors to exempt payments under certain benefit plans and contracts "on account of illness, disability, death, age, or length of service"); § 547(b)(2) (authorizing trustee to avoid a transfer of an interest of the debtor in property "for or on account of an antecedent debt owed by the debtor"); § 547(c)(4)(B) (barring trustee from avoiding a transfer when a creditor gives new value to the debtor "on account of which new value the debtor did not make an otherwise unavoidable transfer to . . . such creditor"). So, under the commonsense rule that a given phrase is meant to carry a given concept in a single statute, see *Cohen* v. *de la Cruz,* 523 U.S. 213, 219-220 (1998), the better reading of subsection (b)(2)(B)(ii) recognizes that a causal relationship between holding the prior claim or interest and receiving or retaining property is what activates the absolute priority rule.

The degree of causation is the final bone of contention. We understand the Government, as *amicus curiae*, to take the starchy position not only that any degree of causation between earlier interests and retained property will activate the bar to a plan providing for later property, Brief for United States as *Amicus Curiae* 11-15, but also that whenever the holders of equity in the Debtor end up with some property there will be some causation; when old equity, and not someone on the street, gets property the reason is *res ipsa loquitur*. An old equity holder simply cannot take property under a plan if

creditors are not paid in full. *Id*., at 10-11, 18. See also Tr. of Oral Arg. 28. [23]

23 Our interpretation of the Government's position in this respect is informed by its view as *amicus curiae* in the *Bonner Mall* case: "the language and structure of the Code prohibit in all circumstances confirmation of a plan that grants the prior owners an equity interest in the reorganized debtor over the objection of a class of unpaid unsecured claims." Brief for United States as *Amicus Curiae* in *United States Bancorp Mortgage Co.* v. *Bonner Mall Partnership*, O. T. 1993, No. 93-714, p. 14.

The Government conceded that, in the case before us, it had no need to press this more stringent view, since "whatever [the] definition of 'on account of,' a 100 percent certainty that junior equity obtains property because they're junior equity will satisfy that." See Tr. of Oral Arg. 29 (internal quotation marks added).

**[*452] [**1421] [***LEdHR2A]** [2A]There are, however, reasons counting against such a reading. If, as is likely, the drafters were treating junior claimants or interest holders as a class at this point (see *Ahlers*, 485 U.S. at 202), [24] then the simple way **[***622]** to have prohibited the old interest holders from receiving anything over objection would have been to omit the "on account of " phrase entirely from subsection (b)(2)(B)(ii). On this assumption, reading the provision as a blanket prohibition would leave "on account of " as a redundancy, contrary to the interpretive obligation to try to give meaning to all the statutory language. See, *e.g*., *Moskal* v. *United States*, 498 U.S. 103, 109-110, 112 L. Ed. 2d 449, 111 S. Ct. 461 (1990); *United States* v. *Menasche,* 348 U.S. 528, 538-539, 99 L. Ed. 615, 75 S. Ct. 513 (1955). [25] One would also have to ask why Congress **[*453]** would have desired to exclude prior equity categorically from the class of potential owners following a cramdown. Although we have some doubt about the Court of Appeals's assumption (see 126 F.3d at 966, and n. 12) that prior equity is often the only source of significant capital for reorganizations, see, *e.g*., Blum & Kaplan, The Absolute Priority Doctrine in Corporate Reorganizations, 41 U. Chi. L. Rev. 651, 672 (1974); Mann, Strategy and Force in the Liquidation of Secured Debt, 96 Mich. L. Rev. 159, 182-183, 192-194, 208-209 (1997), old equity may well be in the best position to make a go of the reorganized enterprise and so may be the party most likely to work out an equity-for-value reorganization.

24 It is possible, on the contrary, to argue on the basis of the immediate text that the prohibition against receipt of an interest "on account of " a prior unsecured claim or interest was meant to indicate only that there is no *per se* bar to such receipt by a creditor holding both a senior secured claim and a junior unsecured one, when the senior secured claim accounts for the subsequent interest. This reading would of course eliminate the phrase "on account of" as an express source of a new value exception, but would leave open the possibility of interpreting the absolute priority rule itself as stopping short of prohibiting a new value transaction.

25 **[***LedHR2B] [***LEdHR2A]** [2B]

Given our obligation to give meaning to the "on account of " modifier, we likewise do not rely on various statements in the House Report or by the bill's floor leaders, which, when read out of context, imply that Congress intended an emphatic, unconditional absolute priority rule. See, *e.g*., H. R. Rep. No. 95-595, p. 224 (1977) ("The bill requires that the plan pay any dissenting class in full before any class junior to the dissenter may be paid at all"); *id*., at 413 ("If [an impaired class is] paid less than in full, then no class junior may receive anything under the plan"); 124 Cong. Rec. 32408 (1978) (statement of Rep. Edwards) (cramdown plan confirmable only "as long as no class junior to the dissenting class receives anything at all"); *id*., at 34007 (statement of Sen. DeConcini) (same).

**[***LEdHR3]** [3]A less absolute statutory prohibition would follow from reading the "on account of" language as intended to reconcile the two recognized policies underlying Chapter 11, of preserving going concerns and maximizing property available to satisfy creditors, see *Toibb* v. *Radloff,* 501 U.S. 157, 163, 115 L. Ed. 2d 145, 111 S. Ct. 2197 (1991). Causation between the old equity's holdings and subsequent property substantial enough to disqualify a plan would presumably occur on this view of things whenever old equity's later property would come at a price that failed to provide the greatest possible addition to the bankruptcy estate, and it

would always come at a price too low when the equity holders obtained or preserved an ownership interest for less than someone else would have paid. [26] A truly full **[*454]** value **[**1422]** transaction, on the other hand, would pose no **[***623]** threat to the bankruptcy estate not posed by any reorganization, provided of course that the contribution be in cash or be realizable money's worth, just as *Ahlers* required for application of *Case*'s new value rule. Cf. *Ahlers, supra,* at 203-205; *Case,* 308 U.S. at 121.

26 Even when old equity would pay its top dollar and that figure was as high as anyone else would pay, the price might still be too low unless the old equity holders paid more than anyone else would pay, on the theory that the "necessity" required to justify old equity's participation in a new value plan is a necessity for the participation of old equity as such. On this interpretation, disproof of a bargain would not satisfy old equity's burden; it would need to show that no one else would pay as much. See, *e.g.*, *In re Coltex Loop Central Three Partners, L. P.*, 138 F.3d 39, 45 (CA2 1998) ("Old equity must be willing to contribute more money than any other source" (internal quotation marks and citation omitted)); Strub, 111 Banking L. J., at 243 (old equity must show that the reorganized entity "needs funds *from the prior owner-managers* because no other source of capital is available"). No such issue is before us, and we emphasize that our holding here does not suggest an exhaustive list of the requirements of a proposed new value plan.

IV

**[***LEdHR1A]** [1C] **[***LEdHR4]** [4]Which of these positions is ultimately entitled to prevail is not to be decided here, however, for even on the latter view the Bank's objection would require rejection of the plan at issue in this case. It is doomed, we can say without necessarily exhausting its flaws, by its provision for vesting equity in the reorganized business in the Debtor's partners without extending an opportunity to anyone else either to compete for that equity or to propose a competing reorganization plan. Although the Debtor's exclusive opportunity to propose a plan under § 1121(b) is not itself "property" within the meaning of subsection (b)(2)(B)(ii), the respondent partnership in this case has taken advantage of this opportunity by proposing a plan under which the benefit of equity ownership may be obtained by no one but old equity partners. Upon the court's approval of that plan, the partners were in the same position that they would have enjoyed had they exercised an exclusive option under the plan to buy the equity in the reorganized entity, or contracted to purchase it from a seller who had first agreed to deal with no one else. It is quite true that the escrow of the partners' proposed investment eliminated any formal need to set out an express **[*455]** option or exclusive dealing provision in the plan itself, since the court's approval that created the opportunity and the partners' action to obtain its advantage were simultaneous. But before the Debtor's plan was accepted no one else could propose an alternative one, and after its acceptance no one else could obtain equity in the reorganized entity. At the moment of the plan's approval the Debtor's partners necessarily enjoyed an exclusive opportunity that was in no economic sense distinguishable from the advantage of the exclusively entitled offeror or option holder. This opportunity should, first of all, be treated as an item of property in its own right. Cf. *In re Coltex Loop Central Three Partners, L. P.*, 138 F.3d at 43 (exclusive right to purchase post-petition equity is itself property); *In re Bryson Properties, XVII*, 961 F.2d at 504; *Kham & Nate's Shoes No. 2, Inc.* v. *First Bank*, 908 F.2d 1351, 1360 (CA7 1990); D. Baird, The Elements of Bankruptcy 261 (rev. ed. 1993) ("The right to get an equity interest for its fair market value is 'property' as the word is ordinarily used. Options to acquire an interest in a firm, even at its market value, trade for a positive price"). While it may be argued that the opportunity has no market value, being significant only to old equity holders owing to their potential tax liability, such an argument avails the Debtor nothing, for several reasons. It is to avoid just such arguments that the law is settled that any otherwise cognizable property **[***624]** interest must be treated as sufficiently valuable to be recognized under the Bankruptcy Code. See *Ahlers,* 485 U.S. at 207-208. Even aside from that rule, the assumption that no one but the Debtor's partners might pay for such an opportunity would obviously support no inference that it is valueless, let alone that it should not be treated as property. And, finally, the source in the tax law of the opportunity's value to the partners implies in no way that it lacks value to others. It might, indeed, be valuable to another precisely as a way to keep the Debtor from implementing a plan that would avoid a Chapter 7 liquidation.

**[*456]** **[***LEdHR1A]** [1D]Given that the

opportunity is property of some value, the question arises why old equity alone should obtain it, not to mention at no cost whatever. The closest thing to an answer favorable to the Debtor is that the old equity partners would be given the opportunity in the expectation that in taking advantage of it they would add the stated purchase price to the estate. See Brief for Respondent 40-41. But this just begs the question why the opportunity should be exclusive to the old equity holders. If the price **[**1423]** to be paid for the equity interest is the best obtainable, old equity does not need the protection of exclusiveness (unless to trump an equal offer from someone else); if it is not the best, there is no apparent reason for giving old equity a bargain. There is no reason, that is, unless the very purpose of the whole transaction is, at least in part, to do old equity a favor. And that, of course, is to say that old equity would obtain its opportunity, and the resulting benefit, because of old equity's prior interest within the meaning of subsection (b)(2)(B)(ii). Hence it is that the exclusiveness of the opportunity, with its protection against the market's scrutiny of the purchase price by means of competing bids or even competing plan proposals, renders the partners' right a property interest extended "on account of" the old equity position and therefore subject to an unpaid senior creditor class's objection.

It is no answer to this to say that the exclusive opportunity should be treated merely as a detail of the broader transaction that would follow its exercise, and that in this wider perspective no favoritism may be inferred, since the old equity partners would pay something, whereas no one else would pay anything. If this argument were to carry the day, of course, old equity could obtain a new property interest for a dime without being seen to receive anything on account of its old position. But even if we assume that old equity's plan would not be confirmed without satisfying the judge that the purchase price was top dollar, there is a further reason here not to treat property consisting of an exclusive opportunity as subsumed within the total transaction **[*457]** proposed. On the interpretation assumed here, it would, of course, be a fatal flaw if old equity acquired or retained the property interest without paying full value. It would thus be necessary for old equity to demonstrate its payment of top dollar, but this it could not satisfactorily do when it would receive or retain its property under a plan giving it exclusive rights and in the absence of a competing plan of **[***625]** any sort. [27] Under a plan granting an exclusive right, making no provision for competing bids or competing plans, any determination that the price was top dollar would necessarily be made by a judge in bankruptcy court, whereas the best way to determine value is exposure to a market. See Baird, Elements of Bankruptcy at 262; Bowers, Rehabilitation, Redistribution or Dissipation: The Evidence for Choosing Among Bankruptcy Hypotheses, 72 Wash. U. L. Q. 955, 959, 963 n. 34, 975 (1994); Markell, 44 Stan. L. Rev., at 73 ("Reorganization practice illustrates that the presence of competing bidders for a debtor, whether they are owners or not, tends to increase creditor dividends"). This is a point of some significance, since it was, after all, one of the Code's innovations to narrow the occasions for courts to make valuation judgments, as shown by its preference for the supramajoritarian class creditor voting scheme in § 1126(c), see *Ahlers, supra,* at 207 ("The Code provides that it is up to the creditors -- and not the courts -- to accept or reject a reorganization plan which fails to provide them adequate protection or fails to honor the absolute priority rule"). [28] In the **[**1424]** interest of statutory coherence, a like disfavor **[*458]** for decisions untested by competitive choice ought to extend to valuations in administering subsection (b)(2)(B)(ii) when some form of market valuation may be available to test the adequacy of an old equity holder's proposed contribution.

27 The dissent emphasizes the care taken by the Bankruptcy Judge in examining the valuation evidence here, in arguing that there is no occasion for us to consider the relationship between valuation process and top-dollar requirement. *Post*, at 5 n.7. While we agree with the dissent as to the judge's conscientious handling of the matter, the ensuing text of this opinion sets out our reasons for thinking the Act calls for testing valuation by a required process that was not followed here.

28 In *Ahlers*, we explained: "The Court of Appeals may well have believed that petitioners or other unsecured creditors would be better off if respondents' reorganization plan was confirmed. But that determination is for the creditors to make in the manner specified by the Code. 11 U.S.C. § 1126(c). Here, the principal creditors entitled to vote in the class of unsecured creditors (*i.e.*, petitioners) objected to the proposed

> reorganization. This was their prerogative under the Code, and courts applying the Code must effectuate their decision." 485 U.S. at 207. The voting rules of Chapter 11 represent a stark departure from the requirements under the old Act. "Congress adopted the view that creditors and equity security holders are very often better judges of the debtor's economic viability and their own economic self-interest than courts, trustees, or the SEC . . . . Consistent with this new approach, the Chapter 11 process relies on creditors and equity holders to engage in negotiations toward resolution of their interests." Brunstad, Sigal, & Schorling, Review of the Proposals of the National Bankruptcy Review Commission Pertaining to Business Bankruptcies: Part One, 53 Bus. Law. 1381, 1406, n. 136 (1998).

Whether a market test would require an opportunity to offer competing plans or would be satisfied by a right to bid for the same interest sought by old equity, is a question we do not decide here. It is enough to say, assuming a new value corollary, that plans providing junior interest holders with exclusive opportunities free from competition and without benefit of market valuation fall within the prohibition of § 1129(b)(2)(B)(ii).

The judgment of the Court of Appeals is accordingly reversed, and the case is remanded for further proceedings consistent with this opinion.

It is so ordered.

**CONCUR BY:** THOMAS

**CONCUR**

**[***626]** JUSTICE THOMAS, with whom JUSTICE SCALIA joins, concurring in the judgment.

I agree with the majority's conclusion that the reorganization plan in this case could not be confirmed. However, I do **[*459]** not see the need for its unnecessary speculations on certain issues and do not share its approach to interpretation of the Bankruptcy Code. I therefore concur only in the judgment.

I

Our precedents make clear that an analysis of any statute, including the Bankruptcy Code, must not begin with external sources, but with the text itself. See, *e.g., Connecticut Nat. Bank* v. *Germain* , 503 U.S. 249, 253-254, 117 L. Ed. 2d 391, 112 S. Ct. 1146 (1992); *Union Bank* v. *Wolas*, 502 U.S. 151, 154, 116 L. Ed. 2d 514, 112 S. Ct. 527 (1991). The relevant Code provision in this case, 11 U.S.C. § 1129(b), does not expressly authorize prepetition equity holders to receive or retain property in a reorganized entity in exchange for an infusion of new capital. [1] Instead, it is cast in general terms and requires that, to be confirmed over the objections of an impaired class of creditors, a reorganization plan be "fair and equitable." § 1129(b)(1). With respect to an impaired class of unsecured creditors, a plan can be fair and equitable only if, at a minimum, it "provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim," § 1129(b)(2)(B)(i), or if "the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property," § 1129(b) (2)(B)(ii).

> 1 In this respect, § 1129 differs from other provisions of the Code, which permit owners to retain property before senior creditors are paid. See, *e.g.,* 11 U.S.C. § 1225(b)(1)(B) (allowing a debtor to retain non-disposable income); § 1325(b)(1)(B) (same).

Neither condition is met here. The Bank did not receive property under the reorganization plan equal to the amount of its unsecured deficiency claim. See *ante*, at 3-4. Therefore, the plan could not satisfy the first condition. With respect to the second condition, the prepetition equity holders **[*460]** received at least two forms of property under the plan: the exclusive opportunity to obtain equity, *ante*, at 18-22, and an equity interest in the reorganized entity. The plan could not be confirmed if the prepetition equity holders received any of this property "on account of" their junior interest.

The meaning of the phrase "on account of" is the central interpretive question presented by this case. This phrase obviously denotes some type of causal relationship between the junior interest and the property received or retained -- such an interpretation comports with common understandings of the phrase. See, *e.g.,* The Random House Dictionary of the English Language 13

(2d ed. 1987) ( **[***627]** "by reason of," "because of'"); Webster's Third New International Dictionary 13 (1976) ("for the sake of," "by reason of," "because of "). It also tracks the use of the phrase elsewhere in **[**1425]** the Code. See, *e.g.,* 11 U.S.C. §§ 365(f)(3), 510(b), 1111(b)(1)(A); see generally § 1129. Regardless how direct the causal nexus must be, the prepetition equity holders here undoubtedly received at least one form of property -- the exclusive opportunity -- "on account of" their prepetition equity interest. *Ante*, at 19. Since § 1129(b)(2)(B)(ii) prohibits the prepetition equity holders from receiving "any" property under the plan on account of their junior interest, this plan was not "fair and equitable" and could not be confirmed. That conclusion, as the majority recognizes, *ante*, at 18, is sufficient to resolve this case. Thus, its comments on the Government's position taken in another case, *ante*, at 15-18, and its speculations about the desirability of a "market test," *ante*, at 22-23, are dicta binding neither this Court nor the lower federal courts.

II

The majority also underestimates the need for a clear method for interpreting the Bankruptcy Code. It extensively surveys pre-Code practice and legislative history, *ante*, at 8-13, but fails to explain the relevance of these sources to the interpretive question apart from the conclusory **[*461]** assertion that the Code's language is "inexact" and the history is "helpful." *Ante*, at 8. This sort of approach to interpretation of the Bankruptcy Code repeats a methodological error committed by this Court in *Dewsnup* v. *Timm*, 502 U.S. 410, 116 L. Ed. 2d 903, 112 S. Ct. 773 (1992).

In *Dewsnup*, the Court held, based on pre-Code practice, that § 506(d) of the Code prevented a Chapter 7 debtor from stripping down a creditor's lien on real property to the judicially determined value of the collateral. 502 U.S. at 419-420. The Court justified its reliance on such practice by finding the provision ambiguous. *Id.,* at 416. Section 506 was ambiguous, in the Court's view, simply because the litigants and *amici* had offered competing interpretations of the statute. *Ibid.* This is a remarkable and untenable methodology for interpreting any statute. If litigants' differing positions demonstrate statutory ambiguity, it is hard to imagine how any provision of the Code -- or any other statute -- would escape *Dewsnup*'s broad sweep. A mere disagreement among litigants over the meaning of a statute does not prove ambiguity; it usually means that one of the litigants is simply wrong. *Dewsnup*'s approach to statutory interpretation enables litigants to undermine the Code by creating "ambiguous" statutory language and then cramming into the Code any good idea that can be garnered from pre-Code practice or legislative history.

The risks of relying on such practice in interpreting the Bankruptcy Code, which seeks to bring an entire area of law under a single, coherent statutory umbrella, are especially weighty. As we previously have recognized, the Code "was intended to modernize the bankruptcy laws, and as a result made significant changes in both the substantive and procedural **[***628]** laws of bankruptcy." *United States* v. *Ron Pair Enterprises, Inc.*, 489 U.S. 235, 240, 103 L. Ed. 2d 290, 109 S. Ct. 1026 (1989) (citation omitted). The Code's overall scheme often reflects substantial departures from various pre-Code practices. Most relevant to this case, the Code created a system of creditor class approval **[*462]** of reorganization plans, unlike early pre-Code practice where plan confirmation depended on unanimous creditor approval and could be hijacked by a single holdout. See D. Baird, The Elements of Bankruptcy 262 (1993). Hence it makes little sense to graft onto the Code concepts that were developed during a quite different era of bankruptcy practice.

Even assuming the relevance of pre-Code practice in those rare instances when the Code is truly ambiguous, see, *e.g., Midlantic Nat. Bank* v. *New Jersey Dept. of Environmental Protection*, 474 U.S. 494, 501, 88 L. Ed. 2d 859, 106 S. Ct. 755 (1986) and assuming that the language here is ambiguous, surely the sparse history behind the new value exception cannot inform the interpretation of § 1129(b)(2)(B)(ii). No holding of this Court ever embraced the new value exception. As noted by the majority, *ante*, at 9, the leading decision suggesting this possibility, *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106, 84 L. Ed. 110, 60 S. Ct. 1 (1939), did so in dictum. And, prior to the Code's enactment, no court ever **[**1426]** relied on the *Case* dictum to approve a plan. Given its questionable pedigree prior to the Code's enactment, a concept developed in dictum and employed by lower federal courts only *after* the Code's enactment is simply not relevant to interpreting this provision of the Code. [2]

2 Nor do I think that the history of rejected legislative proposals bears on the proper

interpretation of the phrase "on account of." As an initial matter, such history is irrelevant for the simple reason that Congress enacted the Code, not the legislative history predating it. See *United States* v. *Estate of Romani*, 523 U.S. 517, 535-537, 140 L. Ed. 2d 710, 118 S. Ct. 1478 (1998) (SCALIA, J., concurring in part and concurring in judgment). Even if this history had some relevance, it would not support the view that Congress intended to insert a new value exception into the phrase "on account of." On the contrary, Congress never acted on bills that would have allowed nonmonetary new value contributions. *Ante*, at 10.

This danger inherent in excessive reliance on pre-Code practice did not escape the notice of the dissenting Justices in *Dewsnup* who expressed "the greatest sympathy for the Courts of Appeals who must predict which manner of statutory **[*463]** construction we shall use for the next Bankruptcy Code case." *Dewsnup, supra,* at 435 (SCALIA, J., joined by SOUTER, J., dissenting). Regrettably, subsequent decisions in the lower courts have borne out the dissenters' fears. The methodological confusion created by *Dewsnup* has enshrouded both the Courts of Appeals and, even more tellingly, Bankruptcy Courts, which must interpret the Code on a daily basis. [3] In the wake of *Dewsnup*, the Fifth Circuit withdrew its decision on the new value exception, prompting **[***629]** the author of the original opinion to observe that *Dewsnup* had clouded "how one should approach issues of a statutory construction arising from the Bankruptcy Code." *In re Greystone III Joint Venture*, 995 F.2d 1274, 1285 (CA5 1991) (Jones, J., dissenting). Unfortunately, the approach taken today only thickens the fog.

3 See, *e.g., In re Southeast Banking Corp.*, 156 F.3d 1114, 1123, n. 16 (CA11 1998); *In re Greystone III Joint Venture*, 995 F.2d 1274 (CA5 1991) (*per curiam*) (vacating prior panel decision regarding new value exception apparently in light of *Dewsnup*); *id.,* at 1285 (Jones, J., dissenting); *In re Kirchner*, 216 B.R. 417, 418 (Bkrtcy. Ct. WD Wis. 1997); *In re Bowen*, 174 B.R. 840, 852-853 (Bkrtcy. Ct. SD Ga. 1994); *In re Dever*, 164 B.R. 132, 138 (Bkrtcy. Ct. CD Cal. 1994); *In re Mr. Gatti's, Inc.*, 162 B.R. 1004, 1010 (Bkrtcy. Ct. WD Tex. 1994); *In re Taffi*, 144 B.R. 105, 112-113 (Bkrtcy. Ct. CD Cal. 1992), rev'd, 72 A. F. T. R. 2d P93-5408, p. 93-6607 (CD Cal. 1993), aff'd in part and rev'd in part, 68 F.3d 306 (CA9 1995), aff'd as modified, 96 F.3d 1190 (CA9 1996) (en banc), cert. denied, 521 U.S. 1103 (1997); *In re A. V. B. I., Inc.*, 143 B.R. 738, 744-745 (Bkrtcy. Ct. CD Cal. 1992), holding rejected by *In re Bonner Mall Partnership*, 2 F.3d 899, 912-913 (CA9 1993), cert. granted, 510 U.S. 1039, vacatur denied and appeal dism'd as moot, 513 U.S. 18 (1994).

**DISSENT BY:** STEVENS

**DISSENT**

JUSTICE STEVENS, dissenting.

Prior to the enactment of the Bankruptcy Reform Act of 1978, this Court unequivocally stated that there are circumstances under which stockholders may participate in a plan of reorganization of an insolvent debtor if their participation is based on a contribution in money, or in money's worth, reasonably equivalent in view of all the circumstances **[*464]** to their participation. [1] As we have on two prior occasions, [2] we granted certiorari in this **[**1427]** case to decide whether § 1129(b)(2)(B)(ii) of the 1978 Act preserved or repealed this "new value" component of the absolute priority rule. I believe the Court should now definitively resolve the question and state that a holder of a junior claim or interest does not receive property "on account of" such a claim when its participation in the plan is based on adequate new value.

1 As Justice Douglas explained in *Case* v. *Los Angeles Lumber Products Co.,* 308 U.S. 106, 84 L. Ed. 110, 60 S. Ct. 1 (1939): "It is, of course, clear that there are circumstances under which stockholders may participate in a plan of reorganization of an insolvent debtor. This Court, as we have seen, indicated as much in *Northern Pacific Ry. Co.* v. *Boyd*[, 228 U.S. 482, 57 L. Ed. 931, 33 S. Ct. 554 (1913),] and *Kansas City Terminal Ry. Co.* v. *Central Union Trust Co.*[, 271 U.S. 445, 70 L. Ed. 1028, 46 S. Ct. 549 (1926)]. Especially in the latter case did this Court stress the necessity, at times, of seeking new money 'essential to the success of the undertaking' from the old stockholders. Where that necessity exists and the old stockholders make a fresh

contribution and receive in return a participation reasonably equivalent to their contribution, no objection can be made. . . .

"In view of these considerations we believe that to accord 'the creditor his full right of priority against the corporate assets' where the debtor is insolvent, the stockholder's participation must be based on a contribution in money or in money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder." 308 U.S. at 121-122 (footnote omitted).

2 See *Norwest Bank Worthington* v. *Ahlers,* 485 U.S. 197, 203, n. 3, 99 L. Ed. 2d 169, 108 S. Ct. 963 (1988); *U.S. Bancorp Mortgage Co.* v. *BonnerMall Partnership,* 513 U.S. 18, 130 L. Ed. 2d 233, 115 S. Ct. 386 (1994).

The Court today wisely rejects the Government's "starchy" position that an old equity holder can never receive an interest in a reorganized venture as a result of a cramdown unless the creditors are first paid in full. *Ante*, at 15-16. [3] Nevertheless, I find the Court's objections to the plan **[*465]** before us unsupported by either the text of **[***630]** 11 U.S.C. § 1129(b)(2)(B)(ii) or the record in this case. I would, therefore, affirm the judgment of the Court of Appeals.

3 As I noted earlier, see n. 1, *supra*, Justice Douglas made this proposition clear in *Case* v. *Los Angeles, supra*. Justice Douglas was a preeminent bankruptcy scholar, well known for his views on the dangers posed by management-controlled corporate reorganizations. Both his work on the Protective Committee Study for the Securities and Exchange Commission and on Chapter X of the Bankruptcy Act sought to "restore the integrity of the reorganization process" which "too often [was] masterminded from behind the scenes by reorganization managers allied with the corporation's management or its bankers." Jennings, Mr. Justice Douglas: His Influence on Corporate and Securities Regulation, 73 Yale L. J. 920, 935-937 (1964). To this end, Douglas placed special emphasis on the protection of creditors' rights in reorganizations. Hopkirk, William O. Douglas -- His Work in Policing Bankruptcy Proceedings, 18 Vand. L. Rev. 663, 685 (1965). I find it implausible that Congress, in enacting the Bankruptcy Code, intended to be even more strict than Justice Douglas in limiting the ability of debtors to participate in reorganizations.

I

Section 1129 of Chapter 11 sets forth in detail the substantive requirements that a reorganization plan must satisfy in order to qualify for confirmation. [4] In the case of dissenting creditor classes, a plan must conform to the dictates of § 1129(b). With only one exception, the requirements of §§ 1129(a) and 1129(b) are identical for plans submitted by stockholders or junior creditors and plans submitted by other parties. That exception is the requirement in § 1129(b)(2)(B)(ii) that no holder of a junior claim or interest may receive or retain any property "on account of such junior claim or interest."

4 "Confirmation of a plan of reorganization is the statutory goal of every chapter 11 case. Section 1129 provides the requirements for such confirmation, containing Congress' minimum requirements for allowing an entity to discharge its unpaid debts and continue its operations." 7 Collier on Bankruptcy P 1129.01 (rev. 15th ed. 1998).

When read in the light of Justice Douglas' opinion in *Case* v. *Los Angeles Lumber Products Co.,* 308 U.S. 106, 84 L. Ed. 110, 60 S. Ct. 1 (1939), the meaning of this provision is perfectly clear. Whenever a junior claimant receives or retains an interest for a bargain price, it does so "on account of" its prior claim. On the other **[*466]** hand, if the new capital that it invests has an equivalent or greater value than its interest in the reorganized venture, it should be equally clear that its participation is based on the fair price being paid and that it is not "on account of" its old claim or equity.

Of course, the fact that the proponents of a plan offer to pay a fair price for the interest they seek to acquire or retain does not necessarily mean that the bankruptcy judge should approve their plan. Any proposed cramdown must satisfy all of the requirements of § 1129 including, most notably, the requirement that the plan be "fair and equitable" to all creditors whose claims are impaired. See § 1129(b)(1). Moreover, even if the old stockholders propose to buy the debtor for a fair price, presumably their plan should not be approved if a third party, perhaps motivated by unique tax or competitive

considerations, is willing to pay an even higher price. Cf. § 1129(c).

In every reorganization case, serious questions concerning the value of the debtor's assets must be resolved. [5] Nevertheless, for **[**1428]** the purpose of answering the legal question presented by the parties to this case, I believe that we should assume that all valuation questions have been correctly answered. If, for example, there had been a widely advertised **[***631]** auction in which numerous bidders participated, and if the plan proposed by respondents had been more favorable by a wide margin than any competing proposal, would § 1129(b)(2)(B)(ii) require rejection of their plan simply because it provides that they shall retain 100% of the equity?

5 See Warren, A Theory of Absolute Priority, 1991 Ann. Survey Am. L. 9, 13 ("In practice, no problem in bankruptcy is more vexing than the problem of valuation").

Petitioner and the Government would reply "yes" because they think § 1129(b)(2)(B)(ii) imposes an absolute ban on participation by junior claimants without the consent of all senior creditors. The Court correctly rejects this extreme position because it would make the words "on account of" **[*467]** superfluous, and because there is no plausible reason why Congress would have desired such a categorical exclusion, given that in some cases old equity may be the most likely source of new capital. See *ante,* at 17. Indeed, the dissenting judge in the Court of Appeals thought "such a result would border on the absurd." [6] Thus, neither the dissenting judge in the Court of Appeals nor the Court appears to be in doubt about the proper answer to my hypothetical question. Instead, the decision is apparently driven by doubts concerning the procedures followed by the Bankruptcy Judge in making his value determinations, implicitly suggesting that the statute should be construed to require some form of competitive bidding in cases like this. [7] See *ante,* at 20-22.

6 Judge Kanne wrote in dissent: "Perhaps the majority's reasoning is driven by the fear that a 'but for' interpretation would prevent old equity from ever participating in a reorganized entity-something Congress could never have intended. Indeed, such a result would border on the absurd, but a simpler, 'but for' causation requirement would not preclude junior interests from participating in a reorganized entity. If prior equity holders earn their shares in an open auction, for example, their received interests would not be 'on account of ' their junior interests but 'on account of' their capital contributions." *In re 203 N. LaSalle Street Partnership*, 126 F.3d 955, 972 (CA7 1997).

It would seem logical for adherents of this view also to find participation by junior interests in the new entity not "on account of" their prior interest, if it were stipulated that old equity's capital contributions exceeded the amount attainable in an auction, or if findings to that effect were not challenged.

7 This doubt is unwarranted in this case. The bank does not challenge the Bankruptcy Court's finding that the 15 floors of office space had a market value of $ 55.8 million. The bank's original expert testimony on the value of the property differed from the Bankruptcy Judge's finding by only 2.8%. *In re 203 North LaSalle Street Partnership*, 190 B.R. 567, 573-576 (Bkrtcy. Ct. ND Ill. 1995). Therefore, although the bank argues that the policy implications of the "new value debate" revolve around judicial determinations of the valuation of the relevant collateral, Brief for Petitioner 5, n. 2, this concern was neither squarely presented in this case nor preserved for our review.

Perhaps such a procedural requirement would be a wise addition to the statute, but it is surely not contained in the **[*468]** present text of § 1129(b)(2)(B)(ii). Indeed, that subsection is not a procedural provision at all. Section 1129 defines the substantive elements that must be met to render plans eligible for confirmation by the bankruptcy judge after all required statutory procedures have been completed. Cf. § 1121 (Who may file a plan); § 1122 (Classification of claims or interests); § 1125 (Postpetition disclosure and solicitation); § 1126 (Acceptance of plan); § 1127 (Modification of plan). Because, as I discuss below, petitioner does not now challenge either the procedures followed by the Bankruptcy Judge or any of his value **[***632]** determinations, neither the record nor the text of § 1129(b)(2)(B)(ii) provides any support for the Court's disposition of this case.

II

As I understand the Court's opinion, it relies on two reasons for refusing to approve the plan at this stage of the proceedings: one based on the plan itself and the other on the confirmation procedures followed before the plan was adopted. In the Court's view, the fatal flaw in the plan proposed by respondent was that it vested complete ownership in the former partners immediately upon confirmation, *ante*, at 18, and the defect in the process was that no other party had an opportunity to propose a competing plan.

These requirements are neither explicitly nor implicitly dictated by the text of the **[**1429]** statute. As for the first objection, if we assume that the partners paid a fair price for what the Court characterizes as their "exclusive opportunity," I do not understand why the retention of a 100% interest in assets is any more "on account of" their prior position than retaining a lesser percentage might have been. Surely there is no legal significance to the fact that immediately after the confirmation of the plan "the partners were in the same position that they would have enjoyed had they exercised an exclusive option under the plan to buy the equity **[*469]** in the reorganized entity, or contracted to purchase it from a seller who had first agreed to deal with no one else." *Ante,* at 19.

As to the second objection, petitioner does not challenge the Bankruptcy Judge's valuation of the property or any of his other findings under § 1129 (other than the plan's compliance with § 1129(b)(2)(B)(ii)). Since there is no remaining question as to value, both the former partners (and the creditors, for that matter) are in the same position that they would have enjoyed if the Bankruptcy Court had held an auction in which this plan had been determined to be the best available. That the court did not hold such an auction should not doom this plan, because no such auction was requested by any of the parties, and the statute does not require that an auction be held. As with all the provisions of § 1129, the question of compliance with § 1129(b)(2)(B)(ii) turns on the substantive content of the plan, not on speculation about the procedures that might have preceded its confirmation.

In this case, the partners had the exclusive right to propose a reorganization plan during the first 120 days after filing for bankruptcy. See § 1121(b). No one contends that that exclusive right is a form of property that is retained by the debtor "on account of" its prior status. [8] The partners did indeed propose a plan which provided for an infusion of $ 6.125 million in new capital in exchange for ownership of the reorganized debtor. Since the tax value of the partnership depended on their exclusive participation, it is unsurprising that the partners' plan did not propose that unidentified outsiders should also be able to own an unspecified portion of the reorganized partnership. It seems both practically **[***633]** and economically puzzling to assume that Congress would have expected old equity to provide for the participation **[*470]** of unknown third parties, who would have interests different (and perhaps incompatible) with the partners', in order to comply with § 1129(b)(2)(B)(ii). [9]

8 Indeed, as the Court acknowledges, *ante,* at 19, it is not "property" within the meaning of the Act.

9 It goes without saying that Congress could not have expected the partners' plan to include a provision that would allow for the Bankruptcy Judge to entertain competing plans, since that is a discretionary decision exclusively within the province of the court. See § 1121(d).

Nevertheless, even after proposing their plan, the partners had no vested right to purchase an equity interest in the postreorganization enterprise until the Bankruptcy Judge confirmed the plan. They also had no assurance that the court would refuse to truncate the exclusivity period and allow other interested parties to file competing plans. As it turned out, the Bankruptcy Judge did not allow respondent to file its proposed plan, but the bank did not appeal that issue, and the question is not before us. [10]

10 Apparently, the bank's plan called for liquidation of the property. In order to flesh out all facts bearing on value, perhaps the Bankruptcy Judge should have terminated the exclusivity period and allowed the bank to file its plan. That the bank's plan called for liquidation of the property in a single-asset context does not necessarily contravene the purposes of Chapter 11. See, *e.g.*, *In re River Village Associates*, 181 B.R. 795, 805 (ED Pa. 1995).

The moment the judge did confirm the partners' plan, the old equity holders were required by law to implement the terms of the plan. [11] It was then, and only then, that what **[*471]** the Court characterizes as the critical "exclusive opportunity" came into existence.

What the Court refuses to recognize, **[**1430]** however, is that this "exclusive opportunity" is the function of the procedural features of this case: the statutory exclusivity period, the Bankruptcy Judge's refusal to allow the bank to file a competing plan, and the inescapable fact that the judge could confirm only one plan.

11 Section 1141(a) states: "Except as provided in subsections (d)(2) and (d)(3) of this section, the provisions of a confirmed plan bind the debtor, any entity issuing securities under the plan, any entity acquiring property under the plan, and any creditor, equity security holder, or general partner in the debtor, whether or not the claim or interest of such creditor, equity security holder, or general partner is impaired under the plan and whether or not such creditor, equity security holder, or general partner has accepted the plan."

See 8 Collier on Bankruptcy P 1141.02. ("Section 1141(a) of the Code provides that a plan is binding upon all parties once it is confirmed. Under this provision, subject to compliance with the requirements of due process under the Fifth Amendment, a confirmed plan is binding upon every entity that holds a claim or interest . . ."); see also § 1142(a).

In this case, the plan provided: "The general partners and limited partners of the Reorganized Debtor shall contribute or cause to be contributed $ 6.125 million of new capital (the "New Capital") to the Reorganized Debtor as follows: $ 3.0 million in cash ("Initial Capital") on the first business banking day after the Effective Date, and $ 625,000 on each of the next five anniversaries of the Effective Date." App. 38-39. The "Effective Date" of the plan was defined as "the first business day after the Confirmation Order is entered on the docket sheet maintained for the Case." *Id.,* at 24.

The Court's repeated references to the partners' "opportunity," see *ante,* at 18, 19, 20, 21, is potentially misleading because it ignores the fact that a plan is binding upon all parties once it is confirmed. One can, of course, refer to contractual rights and duties as "opportunities," but they are not separate property interests comparable to an option which gives its holder a legal right **[***634]** either to enter into a contract or not to do so. They are simply a part of the bundle of contractual terms that have legal significance when a plan is confirmed.

When the court approved the plan, it accepted an offer by old equity. If the value of the debtor's assets has been accurately determined, the fairness of such an offer should be judged by the same standard as offers made by newcomers. Of course, its offer should not receive more favorable consideration "on account of " their prior ownership. But if the debtor's plan would be entitled to approval if it had been submitted by a third party, it should not be disqualified simply because it did not include a unique provision that would **[*472]** not be required in an offer made by any other party, including the creditors.

Since the Court of Appeals correctly interpreted § 1129(b)(2)(B)(ii), its judgment should be affirmed.

Accordingly, I respectfully dissent.

**REFERENCES**

9B Am Jur 2d, Bankruptcy 2492- 2495

11 USCS 1129(b)

L Ed Digest, Bankruptcy 326

L Ed Index, Partnership; Reorganization

Annotation References:

Authority of Congress under bankruptcy clause of Federal Constitution (Art I 8, cl 4) to legislate on the subject of bankruptcies--federal cases. 71 L Ed 2d 905.

# TAB 22

**UNIVERSITY OF TEXAS SOUTHWESTERN MEDICAL CENTER, Petitioner v. NAIEL NASSAR**

**No. 12-484**

**SUPREME COURT OF THE UNITED STATES**

**133 S. Ct. 2517; 186 L. Ed. 2d 503; 2013 U.S. LEXIS 4704; 81 U.S.L.W. 4514; 118 Fair Empl. Prac. Cas. (BNA) 1504; 97 Empl. Prac. Dec. (CCH) P44,851; 24 Fla. L. Weekly Fed. S 366**

**April 24, 2013, Argued**
**June 24, 2013, Decided**

**NOTICE:**

The LEXIS pagination of this document is subject to change pending release of the final published version.

**SUBSEQUENT HISTORY:** On remand at, Remanded by Nassar, MD v. Univ. of Tex. Southwestern Med. Ctr., 537 Fed. Appx. 525, 2013 U.S. App. LEXIS 15869 (5th Cir. Tex., Aug. 1, 2013)

**PRIOR HISTORY:** **[***1]**
ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT
Nassar v. Univ. of Tex. Southwestern Med. Ctr., 674 F.3d 448, 2012 U.S. App. LEXIS 4874 (5th Cir. Tex., 2012)

**DISPOSITION:** Vacated and remanded.

**COUNSEL: Daryl L. Joseffer** argued the cause for petitioner.

**Brian P. Lauten** argued the cause for respondent.

**Melissa Arbus Sherry** argued the cause for the United States, as amicus curiae, by special leave of court.

**JUDGES:** KENNEDY, J., delivered the opinion of the Court, in which ROBERTS, C. J., and SCALIA, THOMAS, and ALITO, JJ., joined. GINSBURG, J., filed a dissenting opinion, in which BREYER, SOTOMAYOR, and KAGAN, JJ., joined.

**OPINION BY:** KENNEDY

**OPINION**

JUSTICE **KENNEDY** delivered the opinion of the Court.

When the law grants persons the right to compensation for injury from wrongful conduct, there must be some demonstrated connection, some link, between the injury sustained and the wrong alleged. The requisite relation **[**512]** between prohibited conduct and compensable injury is governed by the principles of causation, a subject most often arising in elaborating the law of torts. This **[***8]** case requires the Court to define those rules in the context of Title VII of the Civil Rights Act of 1964, 42 U. S. C. § 2000e *et seq.*, which provides remedies to employees for injuries related to discriminatory conduct and associated wrongs by employers.

Title VII is central to the federal policy of prohibiting wrongful discrimination in the Nation's workplaces and in all sectors of economic endeavor. This

opinion discusses the causation rules for two categories of wrongful employer conduct prohibited by Title VII. The first type is called, for purposes of this opinion, status-based discrimination. The term is used here to refer to basic workplace protection such as prohibitions against employer discrimination on the basis of race, color, religion, sex, or national origin, in hiring, firing, salary structure, promotion and the like. See § 2000e-2(a). The second type of conduct is employer retaliation on account of an employee's having opposed, complained of, or sought remedies for, unlawful workplace discrimination. See § 2000e-3(a).

**[**LEdHR1]** [1] An employee who alleges status-based discrimination under Title VII need not show that the causal link between injury and wrong is so close that the injury **[*2523]** **[***9]** would not have occurred but for the act. So-called but-for causation is not the test. It suffices instead to show that the motive to discriminate was one of the employer's motives, even if the employer also had other, lawful motives that were causative in the employer's decision. This principle is the result of an earlier case from this Court, *Price Waterhouse* v. *Hopkins*, 490 U.S. 228, 109 S. Ct. 1775, 104 L. Ed. 2d 268 (1989), and an ensuing statutory amendment by Congress that codified in part and abrogated in part the holding in *Price Waterhouse*, see §§ 2000e-2(m), 2000e-5(g)(2)(B). The question the Court must answer here is whether that lessened causation standard is applicable to claims of unlawful employer retaliation under § 2000e-3(a).

Although the Court has not addressed the question of the causation showing required to establish liability for a Title VII retaliation claim, it has addressed the issue of causation in general in a case involving employer discrimination under a separate but related statute, the Age Discrimination in Employment Act of 1967 (ADEA), 29 U. S. C. § 623. See *Gross* v. *FBL Financial Services, Inc.*, 557 U.S. 167, 129 S. Ct. 2343, 174 L. Ed. 2d 119 (2009). In *Gross*, the Court concluded that **[**LEdHR2]** [2] the ADEA requires proof that the prohibited **[***10]** criterion was the but-for cause of the prohibited conduct. The holding and analysis of that decision are instructive here.

I

Petitioner, the University of Texas Southwestern Medical Center (University), is an academic institution within the University of Texas system. The University specializes in medical education for aspiring physicians, health professionals, and scientists. Over the years, the University has affiliated itself with a number of healthcare facilities including, as relevant in this case, Parkland Memorial Hospital (Hospital). As provided in its affiliation agreement with the University, the Hospital permits the University's students to gain clinical experience working in its facilities. The agreement also requires the Hospital **[**513]** to offer empty staff physician posts to the University's faculty members, see App. 361-362, 366, and, accordingly, most of the staff physician positions at the Hospital are filled by those faculty members.

Respondent is a medical doctor of Middle Eastern descent who specializes in internal medicine and infectious diseases. In 1995, he was hired to work both as a member of the University's faculty and a staff physician at the Hospital. He left both **[***11]** positions in 1998 for additional medical education and then returned in 2001 as an assistant professor at the University and, once again, as a physician at the Hospital.

In 2004, Dr. Beth Levine was hired as the University's Chief of Infectious Disease Medicine. In that position Levine became respondent's ultimate (though not direct) superior. Respondent alleged that Levine was biased against him on account of his religion and ethnic heritage, a bias manifested by undeserved scrutiny of his billing practices and productivity, as well as comments that "'Middle Easterners are lazy.'" 674 F.3d 448, 450 (CA5 2012). On different occasions during his employment, respondent met with Dr. Gregory Fitz, the University's Chair of Internal Medicine and Levine's supervisor, to complain about Levine's alleged harassment. Despite obtaining a promotion with Levine's assistance in 2006, respondent continued to believe that she was biased against him. So he tried to arrange to continue working at the Hospital without also being on the University's faculty. After preliminary negotiations with the Hospital **[*2524]** suggested this might be possible, respondent resigned his teaching post in July 2006 and sent a **[***12]** letter to Dr. Fitz (among others), in which he stated that the reason for his departure was harassment by Levine. That harassment, he asserted, "'stems from . . . religious, racial and cultural bias against Arabs and Muslims.'" *Id.*, at 451. After reading that letter, Dr. Fitz expressed consternation at respondent's accusations, saying that Levine had been "publicly humiliated by th[e] letter" and that it was "very important

that she be publicly exonerated." App. 41.

Meanwhile, the Hospital had offered respondent a job as a staff physician, as it had indicated it would. On learning of that offer, Dr. Fitz protested to the Hospital, asserting that the offer was inconsistent with the affiliation agreement's requirement that all staff physicians also be members of the University faculty. The Hospital then withdrew its offer.

After exhausting his administrative remedies, respondent filed this Title VII suit in the United States District Court for the Northern District of Texas. He alleged two discrete violations of Title VII. The first was a status-based discrimination claim under § 2000e-2(a). Respondent alleged that Dr. Levine's racially and religiously motivated harassment had resulted **[***13]** in his constructive discharge from the University. Respondent's second claim was that Dr. Fitz's efforts to prevent the Hospital from hiring him were in retaliation for complaining about Dr. Levine's harassment, in violation of § 2000e-3(a). 674 F.3d, at 452. The jury found for respondent on both claims. It awarded him over $400,000 in backpay and more than $3 million in compensatory damages. The District Court later reduced the compensatory damages award to $300,000.

On appeal, the Court of Appeals for the Fifth Circuit affirmed in part and **[**514]** vacated in part. The court first concluded that respondent had submitted insufficient evidence in support of his constructive-discharge claim, so it vacated that portion of the jury's verdict. The court affirmed as to the retaliation finding, however, on the theory that retaliation claims brought under § 2000e-3(a)--like claims of status-based discrimination under § 2000e-2(a)--require only a showing that retaliation was a motivating factor for the adverse employment action, rather than its but-for cause. See *id.*, at 454, n. 16 (citing *Smith* v. *Xerox Corp.*, 602 F.3d 320, 330 (CA5 2010)). It further held that the evidence supported a finding that Dr. **[***14]** Fitz was motivated, at least in part, to retaliate against respondent for his complaints against Levine. The Court of Appeals then remanded for a redetermination of damages in light of its decision to vacate the constructive-discharge verdict.

Four judges dissented from the court's decision not to rehear the case en banc, arguing that the Circuit's application of the motivating-factor standard to retaliation cases was "an erroneous interpretation of [Title VII] and controlling caselaw" and should be overruled en banc. 688 F.3d 211, 213-214 (CA5 2012) (Smith, J., dissenting from denial of rehearing en banc).

Certiorari was granted. 568 U.S. ___, 133 S. Ct. 978, 184 L. Ed. 2d 758 (2013).

II

A

This case requires the Court to define the proper standard of causation for Title VII retaliation claims. **[**LEdHR3]** [3] Causation in fact--*i.e.*, proof that the defendant's conduct did in fact cause the plaintiff's injury--is a standard requirement of any tort claim, see Restatement of Torts § 9 (1934) (definition of "legal cause"); § 431, Comment *a* **[*2525]** (same); § 279, and Comment *c* (intentional infliction of physical harm); § 280 (other intentional torts); § 281(c) (negligence). This includes federal statutory claims of workplace discrimination. *Hazen Paper Co.* v. *Biggins*, 507 U.S. 604, 610, 113 S. Ct. 1701, 123 L. Ed. 2d 338 (1993) **[***15]** (In intentional-discrimination cases, "liability depends on whether the protected trait" "actually motivated the employer's decision" and "had a determinative influence on the outcome"); *Los Angeles Dept. of Water and Power* v. *Manhart*, 435 U.S. 702, 711, 98 S. Ct. 1370, 55 L. Ed. 2d 657 (1978) (explaining that the "simple test" for determining a discriminatory employment practice is "whether the evidence shows treatment of a person in a manner which but for that person's sex would be different" (internal quotation marks omitted)).

In the usual course, this standard requires the plaintiff to show "that the harm would not have occurred" in the absence of--that is, but for--the defendant's conduct. Restatement of Torts § 431, Comment *a* (negligence); § 432(1), and Comment *a* (same); see § 279, and Comment *c* (intentional infliction of bodily harm); § 280 (other intentional torts); Restatement (Third) of Torts: Liability for Physical and Emotional Harm § 27, and Comment *b* (2010) (noting the existence of an exception for cases where an injured party can prove the existence of multiple, independently sufficient factual causes, but observing that "cases invoking the concept are rare"). See also Restatement (Second) of Torts § 432(1) **[***16]** (1963 and 1964) (negligence claims); § 870, Comment *l* **[**515]** (intentional injury to another); cf. § 435A, and Comment *a* (legal cause for intentional harm). **[**LEdHR4]** [4] It is thus textbook

tort law that an action "is not regarded as a cause of an event if the particular event would have occurred without it." W. Keeton, D. Dobbs, R. Keeton, & D. Owen, Prosser and Keeton on Law of Torts 265 (5th ed. 1984). This, then, is the background against which Congress legislated in enacting Title VII, and these are the default rules it is presumed to have incorporated, absent an indication to the contrary in the statute itself. See *Meyer* v. *Holley*, 537 U.S. 280, 285, 123 S. Ct. 824, 154 L. Ed. 2d 753 (2003); *Carey* v. *Piphus*, 435 U.S. 247, 257-258, 98 S. Ct. 1042, 55 L. Ed. 2d 252 (1978).

B

Since the statute's passage in 1964, it has prohibited employers from discriminating against their employees on any of seven specified criteria. Five of them--race, color, religion, sex, and national origin--are personal characteristics and are set forth in § 2000e-2. (As noted at the outset, discrimination based on these five characteristics is called status-based discrimination in this opinion.) And then there is a point of great import for this case: The two remaining categories of wrongful employer **[***17]** conduct--the employee's opposition to employment discrimination, and the employee's submission of or support for a complaint that alleges employment discrimination--are not wrongs based on personal traits but rather types of protected employee conduct. These latter two categories are covered by a separate, subsequent section of Title VII, § 2000e-3(a).

Under the status-based discrimination provision, it is an "unlawful employment practice" for an employer "to discriminate against any individual . . . because of such individual's race, color, religion, sex, or national origin." § 2000e-2(a). In its 1989 decision in *Price Waterhouse*, the Court sought to explain the causation standard imposed by this language. It addressed in particular what it means for an action to **[*2526]** be taken "because of" an individual's race, religion, or nationality. Although no opinion in that case commanded a majority, six Justices did agree that a plaintiff could prevail on a claim of status-based discrimination if he or she could show that one of the prohibited traits was a "motivating" or "substantial" factor in the employer's decision. 490 U.S., at 258, 109 S. Ct. 1775, 104 L. Ed. 2d 268 (plurality opinion); *id.*, at 259, 109 S. Ct. 1775, 104 L. Ed. 2d 268 (White, J., concurring in judgment); **[***18]** *id.*, at 276, 109 S. Ct. 1775, 104 L. Ed. 2d 268 (O'Connor, J., concurring in judgment). If the plaintiff made that showing, the burden of persuasion would shift to the employer, which could escape liability if it could prove that it would have taken the same employment action in the absence of all discriminatory animus. *Id.*, at 258, 109 S. Ct. 1775, 104 L. Ed. 2d 268 (plurality opinion); *id.*, at 259-260, 109 S. Ct. 1775, 104 L. Ed. 2d 268 (opinion of White, J.); *id.*, at 276-277, 109 S. Ct. 1775 (opinion of O'Connor, J.). In other words, the employer had to show that a discriminatory motive was not the but-for cause of the adverse employment action.

Two years later, Congress passed the Civil Rights Act of 1991 (1991 Act), 105 Stat. 1071. This statute (which had many other provisions) codified the burden-shifting and lessened-causation framework of *Price Waterhouse* in part but also rejected **[**516]** it to a substantial degree. The legislation first added a new subsection to the end of § 2000e-2, *i.e.*, Title VII's principal ban on status-based discrimination. See § 107(a), 105 Stat. 1075. The new provision, § 2000e-2(m), states:

> **[**LEdHR5]** [5] "[A]n unlawful employment practice is established when the complaining party demonstrates that race, color, religion, sex, or national origin was a motivating factor for any employment practice, **[***19]** even though other factors also motivated the practice."

This, of course, is a lessened causation standard.

The 1991 Act also abrogated a portion of *Price Waterhouse*'s framework by removing the employer's ability to defeat liability once a plaintiff proved the existence of an impermissible motivating factor. See *Gross*, 557 U.S., at 178, n. 5, 129 S. Ct. 2343, 174 L. Ed. 2d 119. In its place, Congress enacted § 2000e-5(g)(2), which provides:

> **[**LEdHR6]** [6] "(B) On a claim in which an individual proves a violation under section 2000e-2(m) of this title and [the employer] demonstrates that [it] would have taken the same action in the absence of the impermissible motivating factor, the court--
>
> "(i) may grant declaratory relief,

injunctive relief . . . and [limited] attorney's fees and costs . . . ; and

"(ii) shall not award damages or issue an order requiring any admission, reinstatement, hiring, promotion, or payment . . . ."

So, in short, the 1991 Act substituted a new burden-shifting framework for the one endorsed by *Price Waterhouse*. Under that new regime, **[**LEdHR7]** [7] a plaintiff could obtain declaratory relief, attorney's fees and costs, and some forms of injunctive relief based solely on proof that race, color, religion, sex, or nationality was a motivating **[***20]** factor in the employment action; but the employer's proof that it would still have taken the same employment action would save it from monetary damages and a reinstatement order. See *Gross*, 557 U.S., at 178, n. 5, 129 S. Ct. 2343, 174 L. Ed. 2d 119; see also *id.*, at 175, n. 2, 177, n. 3, 129 S. Ct. 2343, 174 L. Ed. 2d 119.

After *Price Waterhouse* and the 1991 Act, considerable time elapsed before the Court returned again to the meaning of "because" and the problem of causation. This time it arose in the context of a different, yet similar statute, the ADEA, 29 U. S. C. § 623(a). See *Gross*, *supra*. **[*2527]** Much like the Title VII statute in *Price Waterhouse*, the relevant portion of the ADEA provided that **[**LEdHR8]** [8] "'[i]t shall be unlawful for an employer . . . to fail or refuse to hire or to discharge any individual or otherwise discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, *because of* such individual's age.'" 557 U.S., at 176, 129 S. Ct. 2343, 174 L. Ed. 2d 119 (quoting § 623(a)(1); emphasis and ellipsis in original).

Concentrating first and foremost on the meaning of the phrase "'*because of* . . . age,'" the Court in *Gross* explained that the ordinary meaning of "'because of'" is "'by reason of'" or "'on account of.'" *Id.*, at 176, 129 S. Ct. 2343, 174 L. Ed. 2d 119 (citing 1 **[***21]** Webster's Third New International Dictionary 194 (1966); 1 Oxford English Dictionary 746 (1933); The Random House Dictionary of the English Language 132 (1966); emphasis in original). Thus, **[**LEdHR9]** [9] the "requirement that an employer took adverse action **[**517]** 'because of' age [meant] that age was the 'reason' that the employer decided to act," or, in other words, that "age was the 'but-for' cause of the employer's adverse decision." 557 U.S., at 176, 129 S. Ct. 2343, 174 L. Ed. 2d 119. See also *Safeco Ins. Co. of America* v. *Burr*, 551 U.S. 47, 63-64, 127 S. Ct. 2201, 167 L. Ed. 2d 1045, and n. 14 (2007) (noting that "because of" means "based on" and that "'based on' indicates a but-for causal relationship"); *Holmes* v. *Securities Investor Protection Corporation*, 503 U.S. 258, 265-266, 112 S. Ct. 1311, 117 L. Ed. 2d 532 (1992) (equating "by reason of" with "'but for' cause").

In the course of approving this construction, *Gross* declined to adopt the interpretation endorsed by the plurality and concurring opinions in *Price Waterhouse*. Noting that **[**LEdHR10]** [10] "the ADEA must be 'read . . . the way Congress wrote it,'" 557 U.S., at 179, 129 S. Ct. 2343, 174 L. Ed. 2d 119 (quoting *Meacham* v. *Knolls Atomic Power Laboratory*, 554 U.S. 84, 102, 128 S. Ct. 2395, 171 L. Ed. 2d 283 (2008)), the Court concluded that "the textual differences between Title VII and the ADEA" "prevent[ed] us from applying **[***22]** *Price Waterhouse* . . . to federal age discrimination claims," 557 U.S., at 175, n. 2, 129 S. Ct. 2343, 174 L. Ed. 2d 119. In particular, the Court stressed the congressional choice not to add a provision like § 2000e-2(m) to the ADEA despite making numerous other changes to the latter statute in the 1991 Act. *Id.*, at 174-175, 129 S. Ct. 2343, 174 L. Ed. 2d 119 (citing *EEOC* v. *Arabian American Oil Co.*, 499 U.S. 244, 256, 111 S. Ct. 1227, 113 L. Ed. 2d 274 (1991)); 557 U.S., at 177, n. 3, 129 S. Ct. 2343, 174 L. Ed. 2d 119 (citing *14 Penn Plaza LLC* v. *Pyett*, 556 U.S. 247, 270, 129 S. Ct. 1456, 173 L. Ed. 2d 398 (2009)).

Finally, the Court in *Gross* held that it would not be proper to read *Price Waterhouse* as announcing a rule that applied to both statutes, despite their similar wording and near-contemporaneous enactment. 557 U.S., at 178, n. 5, 129 S. Ct. 2343, 174 L. Ed. 2d 119. This different reading was necessary, the Court concluded, because Congress' 1991 amendments to Title VII, including its "careful tailoring of the 'motivating factor' claim" and the substitution of § 2000e-5(g)(2)(B) for *Price Waterhouse*'s full affirmative defense, indicated that the motivating-factor standard was not an organic part of Title VII and thus could not be read into the ADEA. See 557 U.S., at 178, n. 5, 129 S. Ct. 2343, 174 L. Ed. 2d 119.

In *Gross*, the Court was careful to restrict its analysis

to the statute before it and withhold judgment on **[***23]** the proper resolution of a case, such as this, which arose under Title VII rather than the ADEA. But the particular confines of *Gross* do not deprive it of all persuasive force. Indeed, that opinion holds two insights for the present case. The first is textual and concerns the proper interpretation of the term **[*2528]** "because" as it relates to the principles of causation underlying both § 623(a) and § 2000e-3(a). The second is the significance of Congress' structural choices in both Title VII itself and the law's 1991 amendments. These principles do not decide the present case but do inform its analysis, for the issues possess significant parallels.

III

A

As noted, Title VII's antiretaliation provision, which is set forth in § 2000e-3(a), appears in a different **[**518]** section from Title VII's ban on status-based discrimination. The antiretaliation provision states, in relevant part:

> **[**LEdHR11]** [11] "It shall be an unlawful employment practice for an employer to discriminate against any of his employees . . . because he has opposed any practice made an unlawful employment practice by this subchapter, or because he has made a charge, testified, assisted, or participated in any manner in an investigation, proceeding, or hearing **[***24]** under this subchapter."

**[**LEdHR12]** [12] This enactment, like the statute at issue in *Gross*, makes it unlawful for an employer to take adverse employment action against an employee "because" of certain criteria. Cf. 29 U. S. C. § 623(a)(1). Given the lack of any meaningful textual difference between the text in this statute and the one in *Gross*, the proper conclusion here, as in *Gross*, is that Title VII retaliation claims require proof that the desire to retaliate was the but-for cause of the challenged employment action. See *Gross*, *supra*, at 176, 129 S. Ct. 2343, 174 L. Ed. 2d 119.

The principal counterargument offered by respondent and the United States relies on their different understanding of the motivating-factor section, which--on its face--applies only to status discrimination, discrimination on the basis of race, color, religion, sex, and national origin. In substance, they contend that: (1) retaliation is defined by the statute to be an unlawful employment practice; (2) § 2000e-2(m) allows unlawful employment practices to be proved based on a showing that race, color, religion, sex, or national origin was a motivating factor for--and not necessarily the but-for factor in--the challenged employment action; and (3) the Court has, as **[***25]** a matter of course, held that "retaliation for complaining about race discrimination *is* 'discrimination based on race.'" Brief for United States as *Amicus Curiae* 14; see *id.*, at 11-14; Brief for Respondent 16-19.

There are three main flaws in this reading of § 2000e-2(m). The first is that it is inconsistent with the provision's plain language. It must be acknowledged that because **[**LEdHR13]** [13] Title VII defines "unlawful employment practice" to include retaliation, the question presented by this case would be different if § 2000e-2(m) extended its coverage to all unlawful employment practices. As actually written, however, the text of the motivating-factor provision, while it begins by referring to "unlawful employment practices," then proceeds to address only five of the seven prohibited discriminatory actions--actions based on the employee's status, *i.e.*, race, color, religion, sex, and national origin. This indicates Congress' intent to confine that provision's coverage to only those types of employment practices. The text of § 2000e-2(m) says nothing about retaliation claims. Given this clear language, it would be improper to conclude that what Congress omitted from the statute is nevertheless within **[***26]** its scope. *Gardner* v. *Collins*, 27 U.S. 58, 2 Pet. 58, 93, 7 L. Ed. 347 (1829) ( **[**LEdHR14]** [14] "What the legislative intention was, can be derived only from the words they have used; and we cannot speculate beyond the **[*2529]** reasonable import of these words"); see *Sebelius* v. *Cloer*, 569 U.S. ___, ______, 133 S. Ct. 1886; 185 L. Ed. 2d 1003 (2013).

The second problem with this reading is its inconsistency with the design and structure of the statute as a **[**519]** whole. See *Gross*, 557 U.S., at 175, n. 2, 178, n. 5, 129 S. Ct. 2343, 174 L. Ed. 2d 119. **[**LEdHR15]** [15] Just as Congress' choice of words is presumed to be deliberate, so too are its structural choices. See *id.*, at 177, n. 3, 129 S. Ct. 2343, 174 L. Ed. 2d 119. **[**LEdHR16]** [16] When Congress wrote the motivating-factor provision in 1991, it chose to insert it

as a subsection within § 2000e-2, which contains Title VII's ban on status-based discrimination, §§ 2000e-2(a) to (d), (*l*), and says nothing about retaliation. See 1991 Act, § 107(a), 105 Stat. 1075 (directing that "§ 2000e-2 . . . [be] further amended by adding at the end the following new subsection . . . (m)"). The title of the section of the 1991 Act that created § 2000e-2(m)--"Clarifying prohibition against impermissible consideration of race, color, religion, sex, or national origin in employment practices"--also indicates that Congress determined to **[***27]** address only claims of status-based discrimination, not retaliation. See § 107(a), *id.*, at 1075.

What is more, a different portion of the 1991 Act contains an express reference to all unlawful employment actions, thereby reinforcing the conclusion that **[**LEdHR17]** [17] Congress acted deliberately when it omitted retaliation claims from § 2000e-2(m). See *Arabian American Oil Co.*, 499 U.S., at 256, 111 S. Ct. 1227, 113 L. Ed. 2d 274 (congressional amendment of ADEA on a similar subject coupled with congressional failure to amend Title VII weighs against conclusion that the ADEA's standard applies to Title VII); see also *Gross*, *supra*, at 177, n. 3, 129 S. Ct. 2343, 174 L. Ed. 2d 119. The relevant portion of the 1991 Act, § 109(b), allowed certain overseas operations by U. S. employers to engage in "any practice prohibited by section 703 or 704," *i.e.*, § 2000e-2 or § 2000e-3, "if compliance with such section would cause such employer . . . to violate the law of the foreign country in which such workplace is located." 105 Stat. 1077.

If Congress had desired to make the motivating-factor standard applicable to all Title VII claims, it could have used language similar to that which it invoked in § 109. See *Arabian American Oil Co.*, *supra*, at 256, 111 S. Ct. 1227, 113 L. Ed. 2d 274. Or, it could have inserted the motivating-factor **[***28]** provision as part of a section that applies to all such claims, such as § 2000e-5, which establishes the rules and remedies for all Title VII enforcement actions. See *FDA* v. *Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 160, 120 S. Ct. 1291, 146 L. Ed. 2d 121 (2000). But **[**LEdHR18]** [18] in writing § 2000e-2(m), Congress did neither of those things, and "[w]e must give effect to Congress' choice." *Gross*, *supra*, at 177, n. 3, 129 S. Ct. 2343, 174 L. Ed. 2d 119.

The third problem with respondent's and the Government's reading of the motivating-factor standard is in its submission that this Court's decisions interpreting federal antidiscrimination law have, as a general matter, treated bans on status-based discrimination as also prohibiting retaliation. In support of this proposition, both respondent and the United States rely upon decisions in which this Court has "read [a] broadly worded civil rights statute . . . as including an antiretaliation remedy." *CBOCS West, Inc.* v. *Humphries*, 553 U.S. 442, 452-453, 128 S. Ct. 1951, 170 L. Ed. 2d 864 (2008). In *CBOCS*, for example, the Court held that 42 U. S. C. § 1981--which declares that all persons "shall have the same right . . . to make and enforce contracts . . . as is enjoyed by white citizens"--prohibits **[**520]** not only racial discrimination but also retaliation against **[***29]** those who oppose it. 553 U.S., at 445, 128 S. Ct. 1951, 170 L. Ed. 2d 864. And in **[*2530]** *Gómez-Pérez* v. *Potter*, 553 U.S. 474, 128 S. Ct. 1931, 170 L. Ed. 2d 887 (2008), the Court likewise read a bar on retaliation into the broad wording of the federal-employee provisions of the ADEA. *Id.*, at 479, 487, 128 S. Ct. 1931, 170 L. Ed. 2d 887 ("All personnel actions affecting [federal] employees . . . who are at least 40 years of age . . . shall be made free from any discrimination based on age," 29 U. S. C. § 633a(a)); see also *Jackson* v. *Birmingham Bd. of Ed.*, 544 U.S. 167, 173, 179, 125 S. Ct. 1497, 161 L. Ed. 2d 361 (2005) (20 U. S. C. § 1681(a) (Title IX)); *Sullivan* v. *Little Hunting Park, Inc.*, 396 U.S. 229, 235, n. 3, 237, 90 S. Ct. 400, 24 L. Ed. 2d 386 (1969) (42 U. S. C. § 1982).

These decisions are not controlling here. It is true these cases do state the general proposition that **[**LEdHR19]** [19] Congress' enactment of a broadly phrased antidiscrimination statute may signal a concomitant intent to ban retaliation against individuals who oppose that discrimination, even where the statute does not refer to retaliation in so many words. What those cases do not support, however, is the quite different rule that every reference to race, color, creed, sex, or nationality in an antidiscrimination statute is to be treated as a synonym for "retaliation." For one thing, § 2000e-2(m) is **[***30]** not itself a substantive bar on discrimination. Rather, it is a rule that establishes the causation standard for proving a violation defined elsewhere in Title VII. The cases cited by respondent and the Government do not address rules of this sort, and those precedents are of limited relevance here.

The approach respondent and the Government suggest is inappropriate in the context of a statute as

precise, complex, and exhaustive as Title VII. As noted, the laws at issue in *CBOCS*, *Jackson*, and *Gómez-Pérez* were broad, general bars on discrimination. In interpreting them the Court concluded that by using capacious language Congress expressed the intent to bar retaliation in addition to status-based discrimination. See *Gómez-Pérez*, *supra*, at 486-488, 128 S. Ct. 1931, 170 L. Ed. 2d 887. In other words, when Congress' treatment of the subject of prohibited discrimination was both broad and brief, its omission of any specific discussion of retaliation was unremarkable.

If Title VII had likewise been phrased in broad and general terms, respondent's argument might have more force. But that is not how Title VII was written, which makes it incorrect to infer that Congress meant anything other than what the text does say on the subject **[***31]** of retaliation. Unlike Title IX, § 1981, § 1982, and the federal-sector provisions of the ADEA, Title VII is a detailed statutory scheme. This statute enumerates specific unlawful employment practices. See §§ 2000e-2(a)(1), (b), (c)(1), (d) (status-based discrimination by employers, employment agencies, labor organizations, and training programs, respectively); § 2000e-2(*l*) (status-based discrimination in employment-related testing); § 2000e-3(a) (retaliation for opposing, or making or supporting a complaint about, unlawful employment actions); § 2000e-3(b) (advertising a preference for applicants of a particular race, color, religion, sex, or national origin). It defines key terms, see § 2000e, and exempts certain types of employers, see § 2000e-1. And it creates an administrative **[**521]** agency with both rulemaking and enforcement authority. See §§ 2000e-5, 2000e-12.

This fundamental difference in statutory structure renders inapposite decisions which treated retaliation as an implicit corollary of status-based discrimination. **[**LEdHR20]** [20] Text may not be divorced from context. In light of Congress' special care in drawing so precise a statutory scheme, it would be improper to indulge respondent's suggestion that **[***32]** Congress **[*2531]** meant to incorporate the default rules that apply only when Congress writes a broad and undifferentiated statute. See *Gómez-Pérez*, *supra*, at 486-488, 128 S. Ct. 1931, 170 L. Ed. 2d 887 (when construing the broadly worded federal-sector provision of the ADEA, Court refused to draw inferences from Congress' amendments to the detailed private-sector provisions); *Arabian American Oil Co.*, 499 U.S., at 256, 111 S. Ct. 1227, 113 L. Ed. 2d 274; cf. *Jackson*, *supra*, at 175, 125 S. Ct. 1497, 161 L. Ed. 2d 361 (distinguishing Title IX's "broadly written general prohibition on discrimination" from Title VII's "greater detail [with respect to] the conduct that constitutes discrimination").

Further confirmation of the inapplicability of § 2000e-2(m) to retaliation claims may be found in Congress' approach to the Americans with Disabilities Act of 1990 (ADA), 104 Stat. 327. **[**LEdHR21]** [21] In the ADA Congress provided not just a general prohibition on discrimination "because of [an individual's] disability," but also seven paragraphs of detailed description of the practices that would constitute the prohibited discrimination, see §§ 102(a), (b)(1)-(7), *id.*, at 331-332 (codified at 42 U. S. C. § 12112). And, most pertinent for present purposes, it included an express antiretaliation provision, see § 503(a), 104 Stat. 370 **[***33]** (codified at 42 U. S. C. § 12203). That law, which Congress passed only a year before enacting § 2000e-2(m) and which speaks in clear and direct terms to the question of retaliation, rebuts the claim that Congress must have intended to use the phrase "race, color, religion, sex, or national origin" as the textual equivalent of "retaliation." To the contrary, the ADA shows that when Congress elected to address retaliation as part of a detailed statutory scheme, it did so in clear textual terms.

The Court confronted a similar structural dispute in *Lehman* v. *Nakshian*, 453 U.S. 156, 101 S. Ct. 2698, 69 L. Ed. 2d 548 (1981). The question there was whether the federal-employment provisions of the ADEA, 29 U. S. C. § 633a, provided a jury-trial right for claims against the Federal Government. *Nakshian*, 453 U.S., at 157, 101 S. Ct. 2698, 69 L. Ed. 2d 548. In concluding that it did not, the Court noted that **[**LEdHR22]** [22] the portion of the ADEA that prohibited age discrimination by private, state, and local employers, § 626, expressly provided for a jury trial, whereas the federal-sector provisions said nothing about such a right. *Id.*, at 162-163, 168, 101 S. Ct. 2698, 69 L. Ed. 2d 548. So, too, here. Congress has in explicit terms altered the standard of causation for one class of claims but not another, despite **[***34]** the obvious opportunity to do so in the 1991 Act.

B

The proper interpretation and implementation of § 2000e-3(a) and its causation standard have central importance to the fair and responsible allocation of resources in the judicial and litigation systems. This is of

particular significance because claims of **[**522]** retaliation are being made with ever-increasing frequency. The number of these claims filed with the Equal Employment Opportunity Commission (EEOC) has nearly doubled in the past 15 years--from just over 16,000 in 1997 to over 31,000 in 2012. EEOC, Charge Statistics FY 1997 Through FY 2012, http://www.eeoc.gov/eeoc/statistics/enfo rcement/ charges.cfm (as visited June 20, 2013, and available in Clerk of Court's case file). Indeed, the number of retaliation claims filed with the EEOC has now outstripped those for every type of status-based discrimination except race. See *ibid.*

In addition lessening the causation standard could also contribute to the filing of frivolous claims, which would siphon resources from efforts by employer, administrative agencies, and courts to combat **[*2532]** workplace harassment. Consider in this regard the case of an employee who knows that he or she is about to be fired **[***35]** for poor performance, given a lower pay grade, or even just transferred to a different assignment or location. To forestall that lawful action, he or she might be tempted to make an unfounded charge of racial, sexual, or religious discrimination; then, when the unrelated employment action comes, the employee could allege that it is retaliation. If respondent were to prevail in his argument here, that claim could be established by a lessened causation standard, all in order to prevent the undesired change in employment circumstances. Even if the employer could escape judgment after trial, the lessened causation standard would make it far more difficult to dismiss dubious claims at the summary judgment stage. Cf. *Vance* v. *Ball State Univ.*, *post*, at ___ - ___, 133 S. Ct. ___, 186 L. Ed. 2d 565. It would be inconsistent with the structure and operation of Title VII to so raise the costs, both financial and reputational, on an employer whose actions were not in fact the result of any discriminatory or retaliatory intent. See Brief for National School Boards Association as *Amicus Curiae* 11-22. Yet there would be a significant risk of that consequence if respondent's position were adopted here.

The facts of this case also demonstrate **[***36]** the legal and factual distinctions between status-based and retaliation claims, as well as the importance of the correct standard of proof. Respondent raised both claims in the District Court. The alleged wrongdoer differed in each: In respondent's status-based discrimination claim, it was his indirect supervisor, Dr. Levine. In his retaliation claim, it was the Chair of Internal Medicine, Dr. Fitz. The proof required for each claim differed, too. For the status-based claim, respondent was required to show instances of racial slurs, disparate treatment, and other indications of nationality-driven animus by Dr. Levine. Respondent's retaliation claim, by contrast, relied on the theory that Dr. Fitz was committed to exonerating Dr. Levine and wished to punish respondent for besmirching her reputation. Separately instructed on each type of claim, the jury returned a separate verdict for each, albeit with a single damages award. And the Court of Appeals treated each claim separately, too, finding insufficient evidence on the claim of status-based discrimination.

If it were proper to apply the motivating-factor standard to respondent's retaliation claim, the University might well be subject **[***37]** to liability on account of Dr. Fitz's alleged desire to exonerate Dr. Levine, even if it **[**523]** could also be shown that the terms of the affiliation agreement precluded the Hospital's hiring of respondent and that the University would have sought to prevent respondent's hiring in order to honor that agreement in any event. That result would be inconsistent with the both the text and purpose of Title VII.

In sum, **[**LEdHR23]** [23] Title VII defines the term "unlawful employment practice" as discrimination on the basis of any of seven prohibited criteria: race, color, religion, sex, national origin, opposition to employment discrimination, and submitting or supporting a complaint about employment discrimination. The text of § 2000e-2(m) mentions just the first five of these factors, the status-based ones; and it omits the final two, which deal with retaliation. When it added § 2000e-2(m) to Title VII in 1991, Congress inserted it within the section of the statute that deals only with those same five criteria, not the section that deals with retaliation claims or one of the sections that apply to all claims of unlawful employment practices. And while the Court has inferred a congressional intent to prohibit retaliation **[***38]** when confronted with broadly worded antidiscrimination **[*2533]** statutes, Title VII's detailed structure makes that inference inappropriate here. Based on these textual and structural indications, the Court now concludes as follows: Title VII retaliation claims must be proved according to traditional principles of but-for causation, not the lessened causation test stated in § 2000e-2(m). This requires proof that the unlawful retaliation would not have occurred in the absence of the alleged wrongful action or actions of the employer.

IV

Respondent and the Government also argue that applying the motivating-factor provision's lessened causation standard to retaliation claims would be consistent with longstanding agency views, contained in a guidance manual published by the EEOC. It urges that those views are entitled to deference under this Court's decision in *Skidmore* v. *Swift & Co.*, 323 U.S. 134, 65 S. Ct. 161, 89 L. Ed. 124 (1944). See *National Railroad Passenger Corporation* v. *Morgan*, 536 U.S. 101, 110, n. 6, 122 S. Ct. 2061, 153 L. Ed. 2d 106 (2002). **[**LEdHR24]** [24] The weight of deference afforded to agency interpretations under *Skidmore* depends upon "the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, **[***39]** and all those factors which give it power to persuade." 323 U.S., at 140, 65 S. Ct. 161, 89 L. Ed. 124; see *Vance*, *post*, at ___, n. 4, 133 S. Ct. 2434, 186 L. Ed. 2d 565.

According to the manual in question, the causation element of a retaliation claim is satisfied if "there is credible direct evidence that retaliation was a motive for the challenged action," regardless of whether there is also "[e]vidence as to [a] legitimate motive." 2 EEOC Compliance Manual § 8-II(E)(1), pp. 614:0007-614:0008 (Mar. 2003). After noting a division of authority as to whether motivating-factor or but-for causation should apply to retaliation claims, the manual offers two rationales in support of adopting the former standard. The first is that "[c]ourts have long held that the evidentiary framework for proving [status-based] discrimination . . . also applies to claims of discrimination based on retaliation." *Id.*, at 614:0008, n. 45. Second, the manual states that "an interpretation . . . that permits proven retaliation to go unpunished **[**524]** undermines the purpose of the anti-retaliation provisions of maintaining unfettered access to the statutory remedial mechanism." *Ibid.*

These explanations lack the persuasive force that is a necessary precondition to deference under *Skidmore*. **[***40]** See 323 U.S., at 140, 65 S. Ct. 161, 89 L. Ed. 124; *Vance*, *post*, at ___, n. 4, 133 S. Ct. 2434, 186 L. Ed. 2d 565. As to the first rationale, while the **[**LEdHR25]** [25] settled judicial construction of a particular statute is of course relevant in ascertaining statutory meaning, see *Lorillard* v. *Pons*, 434 U.S. 575, 580-581, 98 S. Ct. 866, 55 L. Ed. 2d 40 (1978), the manual's discussion fails to address the particular interplay among the status-based discrimination provision (§ 2000e-2(a)), the antiretaliation provision (§ 2000e-3(a)), and the motivating-factor provision (§ 2000e-2(m)). Other federal antidiscrimination statutes do not have the structure of statutory subsections that control the outcome at issue here. The manual's failure to address the specific provisions of this statutory scheme, coupled with the generic nature of its discussion of the causation standards for status-based discrimination and retaliation claims, call the manual's conclusions into serious question. See *Kentucky Retirement Systems* v. *EEOC*, 554 U.S. 135, 149-150, 128 S. Ct. 2361, 171 L. Ed. 2d 322 (2008).

The manual's second argument is unpersuasive, too; for its reasoning is circular. It asserts the lessened causation standard is necessary in order to prevent "proven **[*2534]** retaliation" from "go[ing] unpunished." 2 EEOC Compliance Manual § 8-II(E)(1), at 614:0008, **[***41]** n. 45. Yet this assumes the answer to the central question at issue here, which is what causal relationship must be shown in order to prove retaliation.

Respondent's final argument, in which he is not joined by the United States, is that even if § 2000e-2(m) does not control the outcome in this case, the standard applied by *Price Waterhouse* should control instead. That assertion is incorrect. First, this position is foreclosed by the 1991 Act's amendments to Title VII. As noted above, *Price Waterhouse* adopted a complex burden-shifting framework. Congress displaced this framework by enacting § 2000e-2(m) (which adopts the motivating-factor standard for status-based discrimination claims) and § 2000e-5(g)(2)(B) (which replaces employers' total defense with a remedial limitation). See *Gross*, 557 U.S., at 175, n. 2, 177, n. 3, 178, n. 5, 129 S. Ct. 2343, 174 L. Ed. 2d 119. Given the careful balance of lessened causation and reduced remedies Congress struck in the 1991 Act, there is no reason to think that the different balance articulated by *Price Waterhouse* somehow survived that legislation's passage. Second, even if this argument were still available, it would be inconsistent with the *Gross* Court's reading (and the plain **[***42]** textual meaning) of the word "because" as it appears in both § 623(a) and § 2000e-3(a). See *Gross*, *supra*, at 176-177, 129 S. Ct. 2343, 174 L. Ed. 2d 119. For these reasons, the rule of *Price Waterhouse* is not controlling here.

V

**[**LEdHR26]** [26] The text, structure, and history of Title VII demonstrate that a plaintiff making a retaliation claim under § 2000e-3(a) must establish that his or her protected activity was a but-for cause of the alleged adverse action by **[**525]** the employer. The University claims that a fair application of this standard, which is more demanding than the motivating-factor standard adopted by the Court of Appeals, entitles it to judgment as a matter of law. It asks the Court to so hold. That question, however, is better suited to resolution by courts closer to the facts of this case. The judgment of the Court of Appeals for the Fifth Circuit is vacated, and the case is remanded for further proceedings consistent with this opinion.

*It is so ordered.*

**DISSENT BY:** Ginsburg

**DISSENT**

Justice **Ginsburg**, with whom Justice Breyer, Justice Sotomayor, and Justice Kagan join, dissenting.

Title VII of the Civil Rights Act of 1964, 42 U. S. C. § 2000e *et seq.*, makes it an "unlawful employment practice" to "discriminate against any individual . . . *because of* such **[***43]** individual's race, color, religion, sex, or national origin." § 2000e-2(a) (emphasis added). Backing up that core provision, Title VII also makes it an "unlawful employment practice" to discriminate against any individual "*because*" the individual has complained of, opposed, or participated in a proceeding about, prohibited discrimination. § 2000e-3(a) (emphasis added). This form of discrimination is commonly called "retaliation," although Title VII itself does not use that term. The Court has recognized that effective protection against retaliation, the office of § 2000e-3(a), is essential to securing "a workplace where individuals are not discriminated against because of their racial, ethnic, religious, or gender-based status." *Burlington N. & S. F. R. Co.* v. *White*, 548 U.S. 53, 63, 126 S. Ct. 2405, 165 L. Ed. 2d 345 (2006) (*Burlington Northern*). That is so because "fear of retaliation is the leading reason why people stay silent" about the discrimination they have encountered **[*2535]** or observed. *Crawford* v. *Metropolitan Government of Nashville and Davidson Cty.*, 555 U.S. 271, 279, 129 S. Ct. 846, 172 L. Ed. 2d 650 (2009) (internal quotation marks and brackets omitted).

Similarly worded, the ban on discrimination and the ban on retaliation against a discrimination **[***44]** complainant have traveled together: Title VII plaintiffs often raise the two provisions in tandem. Today's decision, however, drives a wedge between the twin safeguards in so-called "mixed-motive" cases. To establish discrimination, all agree, the complaining party need show only that race, color, religion, sex, or national origin was "a motivating factor" in an employer's adverse action; an employer's proof that "other factors also motivated the [action]" will not defeat the discrimination claim. § 2000e-2(m). But a retaliation claim, the Court insists, must meet a stricter standard: The claim will fail unless the complainant shows "but-for" causation, *i.e.*, that the employer would not have taken the adverse employment action but for a design to retaliate.

In so reining in retaliation claims, the Court misapprehends what our decisions teach: Retaliation for complaining about discrimination is tightly bonded to the core prohibition and cannot be disassociated from it. Indeed, this Court has explained again and again that "retaliation in response to a complaint about [proscribed] discrimination *is* discrimination" on the basis of the characteristic **[**526]** Congress sought to immunize against adverse **[***45]** employment action. *Jackson* v. *Birmingham Bd. of Ed.*, 544 U.S. 167, 179, n. 3, 125 S. Ct. 1497, 161 L. Ed. 2d 361 (2005) (emphasis added; internal quotation marks omitted).

The Court shows little regard for the trial judges who will be obliged to charge discrete causation standards when a claim of discrimination "because of," *e.g.*, race is coupled with a claim of discrimination "because" the individual has complained of race discrimination. And jurors will puzzle over the rhyme or reason for the dual standards. Of graver concern, the Court has seized on a provision, § 2000e-2(m), adopted by Congress as part of an endeavor to strengthen Title VII, and turned it into a measure reducing the force of the ban on retaliation.

I

Dr. Naiel Nassar is of Middle Eastern descent. A specialist in the treatment of HIV/AIDS, Nassar was a faculty member of the University of Texas Southwestern Medical Center (UTSW) from 1995 until 2006, save for a period during which he left his employment to continue his education. UTSW is affiliated with Parkland Hospital

and, like other faculty members at the University, Nassar also worked as a physician at the Hospital. Beginning in 2001, Nassar served as Associate Medical Director of the Hospital's **[***46]** Amelia Court Clinic.

Until 2004, Dr. Phillip Keiser, Medical Director of the Clinic, was Nassar's principal supervisor. In that year, UTSW hired Dr. Beth Levine to oversee the Clinic and to supervise Keiser. Before Levine commenced her employment at UTSW, she interviewed her potential subordinates. Meeting with other Clinic doctors for only 15 to 20 minutes, Levine spent an hour and a half with Nassar, engaging in a detailed review of his resume and reading from a list of prepared questions. Record 2926-2928.

Once Levine came on board, she expressed concern to Keiser about Nassar's productivity and questioned his work ethic. *Id.*, at 2361-2362. According to Keiser, Levine "never seemed to [be] satisf[ied]" with his assurances that Nassar was in fact working harder than other physicians. *Id.*, at 2362. Disconcerted by Levine's **[*2536]** scrutiny, Nassar several times complained about it to Levine's supervisor, Dr. Gregory Fitz, Chair of Internal Medicine. App. to Pet. for Cert. 4.

In 2005, Levine opposed hiring another physician who, like Nassar, was of Middle Eastern descent. In Keiser's presence, Levine remarked that "Middle Easterners are lazy." *Id.*, at 3. When that physician was hired by Parkland, **[***47]** Levine said, again in Keiser's presence, that the Hospital had "hired another one." *Ibid.* See also Record 2399-2400. Keiser presented to Levine objective data demonstrating Nassar's high productivity. Levine then began criticizing Nassar's billing practices. Her criticism did not take into account that Nassar's salary was funded by a federal grant that precluded billing for most of his services. App. to Pet. for Cert. 3.

Because of Levine's hostility, Nassar sought a way to continue working at the Clinic without falling under her supervision. To that end, Nassar engaged in discussions with the Hospital about dropping his affiliation with UTSW and retaining his post at Parkland. Although he was initially told **[**527]** that an affiliation agreement between UTSW and Parkland obliged Parkland to fill its staff physician posts with UTSW faculty, talks with the Hospital continued. Eventually, Parkland verbally offered Nassar a position as a staff physician. See App. 67-71, 214-216, 326-330.

In July 2006, Nassar resigned from his position at UTSW. "The primary reason [for his] resignation," Nassar wrote in a letter to Fitz, "[was] the continuing harassment and discrimination . . . by . . . Dr. Beth **[***48]** Levine." App. to Pet. for Cert. 5 (internal quotation marks omitted). According to Keiser, Nassar's letter shocked Fitz, who told Keiser that, because Levine had been "publicly humiliated," she should be "publicly exonerated." App. 41. Fitz's opposition to Parkland's hiring Nassar prompted the Hospital to withdraw the offer to engage him. App. to Pet. for Cert. 5-6.

After accepting a position at a smaller HIV/AIDS clinic in Fresno, California, Nassar filed a complaint with the Equal Employment Opportunity Commission (EEOC). The agency found "credibl[e] testimonial evidence," that UTSW had retaliated against Nassar for his allegations of discrimination by Levine. Brief for Respondent 8 (citing Pl. Trial Exh. 78). Nassar then filed suit in District Court alleging that UTSW had discriminated against him, in violation of Title VII, on the basis of his race, religion, and national origin, see § 2000e-2(a), and had constructively discharged him. App. to Pet. for Cert. 6; Complaint ¶23. He further alleged that UTSW had retaliated against him for complaining about Levine's behavior. App. to Pet. for Cert. 6.

On the retaliation claim, the District Court instructed the jury that Nassar "[did] not **[***49]** have to prove that retaliation was [UTSW's] only motive, but he [had to] prove that [UTSW] acted at least in part to retaliate." *Id.*, at 47. The jury found UTSW liable for both constructive discharge and retaliation. At the remedial phase, the judge charged the jury not to award damages for "actions which [UTSW] prove[d] by a preponderance of the evidence . . . it would have taken even if it had not considered . . . Nassar's protected activity." *Id.*, at 42-43. Finding that UTSW had not met its proof burden, the jury awarded Nassar $438,167.66 in backpay and $3,187,500 in compensatory damages. *Id.*, at 43-44. [1]

1 The District Court reduced compensatory damages to $300,000, the statutory cap under Title VII. See 42 U. S. C. § 1981a(b)(3)(D).

**[*2537]** The Court of Appeals for the Fifth Circuit affirmed in part. [2] Responding to UTSW's argument that the District Court erred in instructing the jury on a mixed-motive theory of retaliation, the Fifth Circuit held that the instruction conformed to Circuit precedent. 674 F.3d 448, 454, n. 16 (2012) (citing *Smith* v. *Xerox Corp.*,

602 F.3d 320, 330 (2010)). [3]

2 The Court of Appeals found the evidence insufficient to support the claim of constructive discharge **[***50]** and reversed the District Court's judgment to that extent. See App. to Pet. for Cert. 8-10. That ruling is not contested here.

3 The Fifth Circuit has since reversed course in an unpublished opinion, concluding that § 2000e-2(m)'s motivating-factor prescription does not apply to retaliation claims. See *Carter* v. *Luminant Power Servs. Co.*, No. 12-10642, 2013 U.S. App. LEXIS 6746, 2013 WL 1337365 (Apr. 3, 2013).

II

This Court has long acknowledged **[**528]** the symbiotic relationship between proscriptions on discrimination and proscriptions on retaliation. Antidiscrimination provisions, the Court has reasoned, endeavor to create a workplace where individuals are not treated differently on account of race, ethnicity, religion, or sex. See *Burlington Northern*, 548 U.S., at 63, 126 S. Ct. 2405, 165 L. Ed. 2d 345. Antiretaliation provisions "see[k] to secure that primary objective by preventing an employer from interfering . . . with an employee's efforts to secure or advance enforcement of [antidiscrimination] guarantees." *Ibid.* As the Court has comprehended, "Title VII depends for its enforcement upon the cooperation of employees who are willing to file complaints and act as witnesses." *Id.*, at 67, 126 S. Ct. 2405, 165 L. Ed. 2d 345. "'[E]ffective enforcement,'" therefore, can "'only be expected **[***51]** if employees . . . [feel] free to approach officials with their grievances.'" *Ibid.* (quoting *Mitchell* v. *Robert DeMario Jewelry, Inc.*, 361 U.S. 288, 292, 80 S. Ct. 332, 4 L. Ed. 2d 323 (1960)). See also *Crawford*, 555 U.S., at 279, 129 S. Ct. 846, 172 L. Ed. 2d 650.

Adverting to the close connection between discrimination and retaliation for complaining about discrimination, this Court has held, in a line of decisions unbroken until today, that a ban on discrimination encompasses retaliation. In *Sullivan* v. *Little Hunting Park, Inc.*, 396 U.S. 229, 237, 90 S. Ct. 400, 24 L. Ed. 2d 386 (1969), the Court determined that 42 U. S. C. § 1982, which provides that "[a]ll citizens of the United States shall have the same right . . . as is enjoyed by white citizens . . . to inherit, purchase, lease, sell, hold, and convey real and personal property," protected a white man who suffered retaliation after complaining of discrimination against his black tenant. *Jackson* v. *Birmingham Board of Education* elaborated on that holding in the context of sex discrimination. "Retaliation against a person because [he] has complained of sex discrimination," the Court found it inescapably evident, "is another form of intentional sex discrimination." 544 U.S., at 173, 125 S. Ct. 1497, 161 L. Ed. 2d 361. As the Court explained:

> "Retaliation is, **[***52]** by definition, an intentional act. It is a form of 'discrimination' because the complainant is being subject to differential treatment. Moreover, retaliation is discrimination 'on the basis of sex' because it is an intentional response to the nature of the complaint: an allegation of sex discrimination." *Id.*, at 173-174, 125 S. Ct. 1497, 161 L. Ed. 2d 361 (citations omitted).

*Jackson* interpreted Title IX of the Educational Amendments of 1972, 20 U. S. C. § 1681(a). Noting that the legislation followed three years after *Sullivan*, the Court found it "not only appropriate but also realistic to presume that Congress **[*2538]** was thoroughly familiar with *Sullivan* and . . . expected its enactment of Title IX to be interpreted in conformity with it." 544 U.S., at 176, 125 S. Ct. 1497, 161 L. Ed. 2d 361 (internal quotation marks and alterations omitted).

*Gómez-Pérez* v. *Potter*, 553 U.S. 474, 128 S. Ct. 1931, 170 L. Ed. 2d 887 (2008), was similarly reasoned. The Court there held that the federal-sector provision of the Age Discrimination in Employment Act of 1967 (ADEA), 29 U. S. C. § 633a(a), barring discrimination "based on age," also proscribes retaliation. 553 U.S., at 479-491, 128 S. Ct. 1931, 170 L. Ed. **[**529]** 2d 887. "What *Jackson* said about the relationship between *Sullivan* and the enactment of Title IX," the Court observed, "can be said as **[***53]** well about the relationship between *Sullivan* and the enactment of the ADEA's federal-sector provision." *Id.*, at 485, 128 S. Ct. 1931, 170 L. Ed. 2d 887. See also *CBOCS West, Inc.* v. *Humphries*, 553 U.S. 442, 447-457, 128 S. Ct. 1951, 170 L. Ed. 2d 864 (2008) (retaliation for race discrimination constitutes discrimination based on race under 42 U. S. C. § 1981). There is no sound reason in this case to stray

from the decisions in *Sullivan*, *Jackson*, *Gómez-Pérez*, and *CBOCS West*.

III

A

The Title VII provision key here, § 2000e-2(m), states that "an unlawful employment practice is established when the complaining party demonstrates that race, color, religion, sex, or national origin was a motivating factor for any employment practice, even though other factors also motivated the practice." Section 2000e-2(m) was enacted as part of the Civil Rights Act of 1991, which amended Title VII, along with other federal antidiscrimination statutes. See 105 Stat. 1071. The amendments were intended to provide "additional protections against unlawful discrimination in employment," *id.*, § 2(3), and to "respon[d] to a number of . . . decisions by [this Court] that sharply cut back on the scope and effectiveness" of antidiscrimination laws, H. R. Rep. No. 102-40, pt. II, pp. 2-4 **[***54]** (1991) (hereinafter House Report Part II) (citing, *inter alia*, *Patterson* v. *McLean Credit Union*, 491 U.S. 164, 109 S. Ct. 2363, 105 L. Ed. 2d 132 (1989); *Martin* v. *Wilks*, 490 U.S. 755, 109 S. Ct. 2180, 104 L. Ed. 2d 835 (1989); *Lorance* v. *AT&T Technologies*, *Inc.*, 490 U.S. 900, 109 S. Ct. 2261, 104 L. Ed. 2d 961 (1989)).

Among the decisions found inadequately protective was *Price Waterhouse* v. *Hopkins*, 490 U.S. 228, 109 S. Ct. 1775, 104 L. Ed. 2d 268 (1989). A plurality of the Court in that case held that the words "because of" in § 2000e-2(a) encompass claims challenging an employment decision attributable to "mixed motives," *i.e.*, one motivated by both legitimate and illegitimate factors. See *id.*, at 240-242, 109 S. Ct. 1775, 104 L. Ed. 2d 268. [4] A Title VII plaintiff, the plurality concluded, need show only that a prohibited factor contributed to the employment decision--not that it was the but-for or sole cause. *Id.*, at 240-244, 109 S. Ct. 1775, 104 L. Ed. 2d 268. But see *id.*, at 281-282, 109 S. Ct. 1775, 104 L. Ed. 2d 268 (Kennedy, J., dissenting). An employer would not be liable, however, if it could show by a preponderance of the evidence that it would have taken the same action absent the illegitimate motive. *Id.*, at 244-245, 109 S. Ct. 1775, 104 L. Ed. 2d 268.

4 Justices White and O'Connor separately concurred and would have required the Title VII plaintiff to show that protected characteristics constituted a *substantial* motivating factor in the adverse employment **[***55]** decision. See *Price Waterhouse* v. *Hopkins*, 490 U.S. 228, 259, 109 S. Ct. 1775, 104 L. Ed. 2d 268 (1989) (White, J., concurring in judgment); *id.*, at 265, 109 S. Ct. 1775, 104 L. Ed. 2d 268 (O'Connor, J., concurring in judgment).

**[*2539]** Congress endorsed the plurality's conclusion that, to be actionable under Title VII, discrimination must be a motivating factor in, but need not be the but-for cause of, an adverse employment action. See House Report Part II, at 18. Congress disagreed with the Court, however, insofar as **[**530]** the *Price Waterhouse* decision allowed an employer to escape liability by showing that the same action would have been taken regardless of improper motive. House Report Part II, at 18. See also H. R. Rep. No. 102-40, pt. I, pp. 45-48 (1991) (hereinafter House Report Part I). "If Title VII's ban on discrimination in employment is to be meaningful," the House Report explained, "victims of intentional discrimination must be able to obtain relief, and perpetrators of discrimination must be held liable for their actions." House Report Part II, at 18.

Superseding *Price Waterhouse* in part, Congress sought to "restore" the rule of decision followed by several Circuits that any discrimination "actually shown to play a role in a contested employment decision **[***56]** may be the subject of liability." House Report Part II, at 18. See also House Report Part I, at 48. To that end, Congress enacted § 2000e-2(m) and § 2000e-5(g)(2)(B). The latter provides that an employer's proof that an adverse employment action would have been taken in any event does not shield the employer from liability; such proof, however, limits the plaintiff's remedies to declaratory or injunctive relief, attorney's fees, and costs.

Critically, the rule Congress intended to "restore" was not limited to substantive discrimination. As the House Report explained, "the Committee endors[ed] . . . the decisional law" in *Bibbs* v. *Block*, 778 F.2d 1318 (CA8 1985) (en banc), which held that a violation of Title VII is established when the trier of fact determines that "an unlawful motive played some part in the employment decision or decisional process." *Id.*, at 1323; see House Report Part I, at 48. Prior to the 1991 Civil Rights Act, *Bibbs* had been applied to retaliation claims. See, *e.g.*, *Johnson* v. *Legal Servs. of Arkansas, Inc.*, 813 F.2d 893,

900 (CA8 1987) ("Should the court find that retaliation played some invidious part in the [plaintiff's] termination, a violation of Title VII **[***57]** will be established under *Bibbs*."). See also *EEOC* v. *General Lines, Inc.*, 865 F.2d 1555, 1560 (CA10 1989).

B

There is scant reason to think that, despite Congress' aim to "restore and strengthen . . . laws that ban discrimination in employment," House Report Part II, at 2, Congress meant to exclude retaliation claims from the newly enacted "motivating factor" provision. Section 2000e-2(m) provides that an "unlawful employment practice is established" when the plaintiff shows that a protected characteristic was a factor driving "any employment practice." Title VII, in § 2000e-3(a), explicitly denominates retaliation, like status-based discrimination, an "unlawful employment practice." Because "any employment practice" necessarily encompasses practices prohibited under § 2000e-3(a), § 2000e-2(m), by its plain terms, covers retaliation.

Notably, when it enacted § 2000e-2(m), Congress did not tie the new provision specifically to §§ 2000e-2(a)-(d), which proscribe discrimination "because of" race, color, religion, gender, or national origin. Rather, Congress added an entirely new provision to codify the causation standard, one encompassing "any employment practice." § 2000e-2(m).

Also telling, § 2000e-2(m) **[***58]** is not limited to situations in which *the complainant's* race, color, religion, sex, or national origin **[*2540]** motivates the employer's action. In contrast, Title VII's **[**531]** substantive antidiscrimination provisions refer to the protected characteristics of the complaining party. See §§ 2000e-2(a)(1)-(2), (c)(2) (referring to "such individual's" protected characteristics); §§ 2000e-2(b), (c)(1), (d) (re-ferring to "his race, color, religion, sex, or national origin"). Congress thus knew how to limit Title VII's coverage to victims of status-based discrimination when it was so minded. It chose, instead, to bring within § 2000e-2(m) "any employment practice." To cut out retaliation from § 2000e-2(m)'s scope, one must be blind to that choice. Cf. *Jackson*, 544 U.S., at 179, n. 3, 125 S. Ct. 1497, 161 L. Ed. 2d 361 (omission of reference to the complaining party's sex in Title IX supports the conclusion that the statute protects a male plaintiff from retaliation in response to complaints about sex discrimination against women).

C

From the inception of § 2000e-2(m), the agency entrusted with interpretation of Title VII and superintendence of the Act's administration, the EEOC, see § 2000e-5, has understood the provision to cover retaliation claims. **[***59]** Shortly after Congress amended Title VII to include the motivating-factor provision, the EEOC issued guidance advising that, "[a]lthough [§ 2000e-2(m)] does not specify retaliation as a basis for finding liability whenever it is a motivating factor for an action, neither does it suggest any basis for deviating from the Commission's long-standing rule that it will find liability . . . whenever retaliation plays any role in an employment decision." EEOC, Revised Enforcement Guidance on Recent Developments in Disparate Treatment Theory, p. 20, n. 14 (July 14, 1992) (hereinafter EEOC Guidance), available at http://www.eeoc.gov/policy/docs/disparat .html (as visited June 21, 2013, and in Clerk of Court's case file). As the EEOC's initial guidance explained, "if retaliation were to go unremedied, it would have a chilling effect upon the willingness of individuals to speak out against employment discrimination." *Ibid.*

In its compliance manual, the EEOC elaborated on its conclusion that "[§ 2000e-2(m)] applies to retaliation." 2 EEOC Compliance Manual § 8-II(E)(1), p. 614:0008, n. 45 (May 20, 1998) (hereinafter EEOC Compliance Manual). That reading, the agency observed, tracked the view, widely **[***60]** held by courts, "that the evidentiary framework for proving employment discrimination based on race, sex, or other protected class status also applies to claims of discrimination based on retaliation." *Ibid.* "[A]n interpretation of [§ 2000e-2(m)] that permit[ted] proven retaliation to go unpunished," the EEOC noted, would "undermin[e] the purpose of the anti-retaliation provisions of maintaining unfettered access to the statutory remedial mechanism." *Ibid.*

The position set out in the EEOC's guidance and compliance manual merits respect. See *Skidmore* v. *Swift & Co.*, 323 U.S. 134, 140, 65 S. Ct. 161, 89 L. Ed. 124 (1944); *Federal Express Corp.* v. *Holowecki*, 552 U.S. 389, 399, 128 S. Ct. 1147, 170 L. Ed. 2d 10 (2008) ("[EEOC's] policy statements, embodied in its compliance manual and internal directives . . . reflect a body of experience and informed judgment. . . . As such, they are entitled to a measure of respect under the less deferential *Skidmore* standard." (internal quotation marks

omitted)). If the breadth of § 2000e-2(m) can be deemed ambiguous (although I believe its meaning is plain), **[**532]** the provision should be construed to accord with the EEOC's well-reasoned and longstanding guidance.

IV

The Court draws the opposite conclusion, ruling that retaliation **[***61]** falls outside **[*2541]** the scope of § 2000e-2(m). In so holding, the Court ascribes to Congress the unlikely purpose of separating retaliation claims from discrimination claims, thereby undermining the Legislature's effort to fortify the protections of Title VII. None of the reasons the Court offers in support of its restrictive interpretation of § 2000e-2(m) survives inspection.

A

The Court first asserts that reading § 2000e-2(m) to encompass claims for retaliation "is inconsistent with the provision's plain language." *Ante*, at ___, 186 L. Ed. 2d, at 518. The Court acknowledges, however, that "the text of the motivating-factor provision . . . begins by referring to unlawful employment practices," a term that undeniably includes retaliation. *Ibid.* (internal quotation marks omitted). Nevermind that, the Court continues, for § 2000e-2(m) goes on to reference as "motivating factor[s]" only "race, color, religion, sex, or national origin." The Court thus sees retaliation as a protected activity entirely discrete from status-based discrimination. *Ibid.*

This vision of retaliation as a separate concept runs up against precedent. See *supra*, at ___ - ___, 186 L. Ed. 2d, at 527-529. Until today, the Court has been clear eyed on just what retaliation is: a manifestation **[***62]** of status-based discrimination. As *Jackson* explained in the context of sex discrimination, "retaliation is discrimination 'on the basis of sex' because it is an intentional response to the nature of the complaint: an allegation of sex discrimination." 544 U.S., at 174, 125 S. Ct. 1497, 161 L. Ed. 2d 361.

The Court does not take issue with *Jackson*'s insight. Instead, it distinguishes *Jackson* and like cases on the ground that they concerned laws in which "Congress' treatment of the subject of prohibited discrimination was both broad and brief." *Ante*, at ___, 186 L. Ed. 2d, at 520. Title VII, by contrast, "is a detailed statutory scheme," that "enumerates specific unlawful employment practices," "defines key terms," and "exempts certain types of employers." *Ante*, at ___, 186 L. Ed. 2d, at 520. Accordingly, the Court says, "it would be improper to indulge [the] suggestion that Congress meant to incorporate [in Title VII] the default rules that apply only when Congress writes a broad and undifferentiated statute." *Ibid.*

It is strange logic indeed to conclude that when Congress homed in on retaliation and codified the proscription, as it did in Title VII, Congress meant protection against that unlawful employment practice to have *less* force than the protection available **[***63]** when the statute does not mention retaliation. It is hardly surprising, then, that our jurisprudence does not support the Court's conclusion. In *Gómez-Pérez*, the Court construed the federal-sector provision of the ADEA, which proscribes "discrimination based on age," 29 U. S. C. § 633a(a), to bar retaliation. The Court did so mindful that another part of the Act, the provision applicable to private-sector employees, explicitly proscribes retaliation and, moreover, "set[s] out a specific list of forbidden employer practices." **[**533]** *Gómez-Pérez*, 553 U.S., at 486-487, 128 S. Ct. 1931, 170 L. Ed. 2d 887 (citing 29 U. S. C. §§ 623(a) and (d)).

The Court suggests that "the la[w] at issue in . . . *Gómez-Pérez* [was a] broad, general ba[r] on discrimination." *Ante*, at ___, 186 L. Ed. 2d, at 520. But, as our opinion in that case observes, some of the ADEA's provisions are brief, broad, and general, while others are extensive, specific, and detailed. 553 U.S., at 487, 128 S. Ct. 1931, 170 L. Ed. 2d 887. So too of Title VII. See *ibid.* ("The ADEA federal-sector provision was patterned directly after Title VII's federal-sector discrimination ban . . . [which] contains a broad prohibition of 'discrimination,' rather than a **[*2542]** list of specific prohibited practices." (some internal quotation marks omitted)). **[***64]** It makes little sense to apply a different mode of analysis to Title VII's § 2000e-2(m) and the ADEA's § 633a(a), both brief statements on discrimination in the context of larger statutory schemes. 5

5 The Court obscures the inconsistency between today's opinion and *Gómez-Pérez* by comparing § 633a to *all of* Title VII. See *ante*, at ___, 186 L. Ed. 2d, at 520 ("Unlike Title IX, § 1981, § 1982, and the federal-sector provisions of the ADEA, Title VII is a detailed statutory scheme."). That

comparison is inapt. Like Title VII, the ADEA is a "detailed statutory scheme." *Ibid.* Compare *ibid.* (citing Title VII provisions that proscribe status-based discrimination by employers, employment agencies, labor organizations, and training programs; bar retaliation; prohibit advertising a preference for certain protected characteristics; define terms; exempt certain employers; and create an agency with rulemaking and enforcement authority), with 29 U. S. C. §§ 623(a)-(e) (proscribing age discrimination by employers, employment agencies, and labor unions; barring retaliation; prohibiting advertising a preference for employees of a particular age), § 628 (granting rulemaking authority to the EEOC), and § 630 (defining terms). Thus, § 633a **[***65]** is just like § 2000e-2(m) in the relevant respect: both are single provisions comprised within a detailed scheme.

The Court's reliance on § 109(b) of the Civil Rights Act of 1991, 105 Stat. 1077,[6] and the Americans with Disabilities Act of 1990 (ADA), 104 Stat. 327, is similarly unavailing. According to the Court, Congress' explicit reference to § 2000e-3(a) in § 109(b) "reinforc[es] the conclusion that Congress acted deliberately when it omitted retaliation claims from § 2000e-2(m)." *Ante*, at ___, 186 L. Ed. 2d, at 519. The same is true of the ADA, the Court says, as "Congress provided not just a general prohibition on discrimination 'because of [an individual's] disability,' but also seven paragraphs of detailed description of the practices that would constitute the prohibited discrimination . . . [a]nd . . . an express antiretaliation provision." *Ante*, at ___, 186 L. Ed. 2d, at 521.

6 Now codified at 42 U. S. C. § 2000e-1(b), § 109(b) provides:

"It shall not be unlawful under § 2000e-2 or 2000e-3 . . . for an employer . . . to take any action otherwise prohibited by such section, with respect to an employee in a workplace in a foreign country if compliance with such section would cause such employer . . . to violate the law of the foreign **[***66]** country in which such workplace is located." The provision was framed to accord with this Court's decision in *EEOC* v. *Arabian American Oil Co.*, 499 U.S. 244, 111 S. Ct. 1227, 113 L. Ed. 2d 274 (1991).

This argument is underwhelming. Yes, Congress has sometimes addressed retaliation explicitly in antidiscrimination statutes. When it does so, there is no occasion for interpretation. But when Congress simply targets discrimination "because of" protected characteristics, or, as in § 2000e-2(m), refers to employment practices motivated by race, color, religion, sex, or national origin, how should courts comprehend those phrases? They should read them informed **[**534]** by this Court's consistent holdings that such phrases draw in retaliation, for, in truth, retaliation is a "form of intentional [status-based] discrimination." See *Jackson*, 544 U.S., at 173, 125 S. Ct. 1497, 161 L. Ed. 2d 361, described *supra*, at ___ - ___, 186 L. Ed. 2d, at 527-529. That is why the Court can point to no prior instance in which an antidiscrimination law was found *not* to cover retaliation. The Court's *volte-face* is particularly imprudent in the context of § 2000e-2(m), a provision added as part of Congress' effort to toughen protections against workplace discrimination.

B

The Court also disassociates retaliation from status-based **[***67]** discrimination by stressing that the bar on the latter appears in § 2000e-2, while the proscription of retaliation **[*2543]** appears in a separate provision, § 2000e-3. Section 2000e-2, the Court asserts, "contains Title VII's ban on status-based discrimination . . . and says nothing about retaliation." *Ante*, at ___, 186 L. Ed. 2d, at 519. Retaliation, the Court therefore concludes, should not be read into § 2000e-2(m). *Ante*, at ___, 186 L. Ed. 2d, at 519.

The Court's reasoning rests on a false premise. Section 2000e-2 does not deal exclusively with discrimination based on protected characteristics. The provisions stated after §§ 2000e-2(a)-(d) deal with a variety of matters, some of them unquestionably covering retaliation. For example, § 2000e-2(n), enacted in tandem with and located immediately after § 2000e-2(m), limits opportunities to collaterally attack employment practices installed to implement a consent judgment. Section 2000e-2(n) applies beyond the substantive antidiscrimination provisions in § 2000e-2; indeed, it applies beyond Title VII to encompass claims "under the Constitution or [other] Federal civil rights laws." § 2000e-2(n)(1)(A). Thus, if an employee sues for retaliatory discharge in violation of § 2000e-3(a), and a consent **[***68]** judgment orders reinstatement, any

person adversely affected by that judgment (*e.g.*, an employee who loses seniority as a result) would generally be barred from attacking the judgment if she was given actual notice of the proposed order and a reasonable opportunity to present objections. That Congress placed the consent-judgment provision in § 2000e-2 and not in § 2000e-3 is of no moment. As the text of the provision plainly conveys, § 2000e-2(n) would reach consent judgments settling complaints about retaliation, just as it would cover consent judgments settling complaints about status-based discrimination.

Section 2000e-2(g) is similarly illustrative. Under that provision, "it shall not be an unlawful employment practice for an employer . . . to discharge [an] individual" if she fails to fulfill any requirement imposed in the interest of national security. Because § 2000e-3(a) renders retaliation an "unlawful employment practice," § 2000e-2(g)'s exemption would no doubt apply to a Title VII retaliatory discharge claim. Given these provisions, Congress' placement of the motivating-factor provision within § 2000e-2 cannot bear the weight the Court places on it. [7]

7 The Court's assertion that **[***69]** we "confronted a similar structural dispute in *Lehman* v. *Nakshian*, 453 U.S. 156, 101 S. Ct. 2698, 69 L. Ed. 2d 548 (1981)," *ante*, at ___, 186 L. Ed. 2d, at 521, assumes its own conclusion. As the Court explains, in *Nakshian*, the plaintiff argued that § 633a of the ADEA afforded the right to trial by jury. 453 U.S., at 157, 101 S. Ct. 2698, 69 L. Ed. 2d 548. An amendment to the private-sector provision, codified at 29 U. S. C. § 626(c), granted that right to plaintiffs suing private employers, as well as state and local governmental entities. But no one argued in *Nakshian* that the private-sector amendment applied to the federal-sector provision. Hence, *Nakshian*'s holding that the ADEA does not permit a federal-sector plaintiff to try her case before a jury is relevant only if the Court is correct that § 2000e-2(m) does not cover retaliation claims.

**[**535]** C

The Court gives no deference to the EEOC's longstanding position that § 2000e-2(m) applies to retaliation because, the Court charges, the agency did not "address the particular interplay among the status-based antidiscrimination provision (§ 2000e-2(a)), the antiretaliation provision (§ 2000e-3(a)), and the motivating-factor provision (§ 2000e-2(m))." *Ante*, at ___, 186 L. Ed. 2d, at 524. Not so.

In its compliance manual, the EEOC noted that some courts had concluded **[***70]** that § 2000e-2(m) does not cover retaliation, citing as an example **[*2544]** *Woodson* v. *Scott Paper Co.*, 109 F.3d 913 (CA3 1997). In that decision, the Third Circuit acknowledged it was "given pause by the fact that . . . courts have generally borrowed from discrimination law in determining the burdens and order of proof in retaliation cases." *Id.*, at 934. One could therefore say, the Third Circuit continued, that "Congress knew of the practice of borrowing in retaliation cases, and presumed that courts would continue this practice after the 1991 Act." *Ibid.*

While *Woodson* rejected that argument, the EEOC found it sound. See EEOC Compliance Manual, at 614:0008, n. 45 ("Courts have long held that the evidentiary framework for proving employment discrimination based on race, sex, or other protected class status also applies to claims of discrimination based on retaliation."). See also EEOC Guidance, at 20, n. 14 (while § 2000e-2(m) does not explicitly refer to retaliation, nothing in the provision calls for deviation from the longstanding practice of finding liability when a plaintiff demonstrates that retaliatory intent motivated an adverse employment decision). By adverting to *Woodson*, the EEOC **[***71]** made clear that it considered the very argument the Court relies on today. Putting down the agency's appraisal as "generic," *ante*, at ___, 186 L. Ed. 2d, at 524, is thus conspicuously unfair comment.

The Court's second reason for refusing to accord deference to the EEOC fares no better. The EEOC's conclusion that "the lessened causation standard is necessary in order to prevent 'proven retaliation' from 'go[ing] unpunished,'" the Court reasons, "is circular" because it "assumes the answer to the central question at issue here, which is what causal relationship must be shown in order to prove retaliation." *Ibid.* That reasoning will not wash. Under the motivating-factor test set out in § 2000e-2(m), a plaintiff prevails if she shows that proscribed conduct "was a motivating factor" for the adverse employment action she encountered, "even though other factors also motivated the [action]." She will succeed, although the relief to which she is entitled may be restricted. See *supra*, at ___, 186 L. Ed. 2d, at 529.

Under the Court's view, proof that retaliation was a factor motivating an adverse employment action is insufficient to establish liability under § 2000e-3(a). The **[**536]** Court's but-for causation standard does not mean that the plaintiff **[***72]** has failed to prove she was subjected to unlawful retaliation. It does mean, however, that proof of a retaliatory motive alone yields no victory for the plaintiff. Put otherwise, the Court's view "permits proven retaliation to go unpunished," just as the EEOC recognized. See EEOC Compliance Manual, at 614:0008, n. 45.

V

A

Having narrowed § 2000e-2(m) to exclude retaliation claims, the Court turns to *Gross* v. *FBL Financial Services, Inc.*, 557 U.S. 167, 129 S. Ct. 2343, 174 L. Ed. 2d 119 (2009), to answer the question presented: Whether a plaintiff must demonstrate but-for causation to establish liability under § 2000e-3(a).

The Court held in *Gross* that, in contrast to Title VII, § 623(a) of the ADEA does not authorize any age discrimination claim asserting mixed motives. Explaining that uniform interpretation of the two statutes is sometimes unwarranted, the Court noted in *Gross* that the phrase "because of . . . age" in § 623(a) has not been read "to bar discrimination against people of all ages, even though the Court had previously interpreted 'because of . . . race [or] sex' in Title VII to bar discrimination against people of all races and both sexes." 557 U.S., at 175, n. 2, 129 S. Ct. 2343, 174 L. Ed. 2d 119. Yet *Gross*, which took pains to distinguish **[*2545]** ADEA **[***73]** claims from Title VII claims, is invoked by the Court today as pathmarking. See *ante*, at ___, 186 L. Ed. 2d, at 512 ("The holding and analysis of [*Gross*] are instructive here.").

The word "because" in Title VII's retaliation provision, § 2000e-3(a), the Court tells us, should be interpreted not to accord with the interpretation of that same word in the companion status-based discrimination provision of Title VII, § 2000e-2(a). Instead, statutory lines should be crossed: The meaning of "because" in Title VII's retaliation provision should be read to mean just what the Court held "because" means for ADEA-liability purposes. But see *Gross*, 557 U.S., at 174, 129 S. Ct. 2343, 174 L. Ed. 2d 119 ("When conducting statutory interpretation, we 'must be careful not to apply rules applicable under one statute to a different statute without careful and critical examination.'"(quoting *Holowecki*, 552 U.S., at 393, 128 S. Ct. 1147, 170 L. Ed. 2d 10)). In other words, the employer prevailed in *Gross* because, according to the Court, the ADEA's antidiscrimination prescription is not like Title VII's. But the employer prevails again in Nassar's case, for there is no "meaningful textual difference," *ante*, at ___, 186 L. Ed. 2d, at 518, between the ADEA's use of "because" and the use of the same word in Title VII's retaliation **[***74]** provision. What sense can one make of this other than "heads the employer wins, tails the employee loses"?

It is a standard principle of statutory interpretation that identical phrases appearing in the same statute--here, Title VII--ordinarily bear a consistent meaning. See *Powerex Corp.* v. *Reliant Energy Services, Inc.*, 551 U.S. 224, 232, 127 S. Ct. 2411, 168 L. Ed. 2d 112 (2007). Following that principle, Title VII's retaliation provision, like its status-based discrimination provision, would permit mixed-motive claims, and the same causation standard would apply to both provisions.

**[**537]** B

The Court's decision to construe § 2000e-3(a) to require but-for causation in line with *Gross* is even more confounding in light of *Price Waterhouse*. Recall that *Price Waterhouse* interpreted "because of" in § 2000e-2(a) to permit mixed-motive claims. See *supra*, at ___, 186 L. Ed. 2d, at 529. The Court today rejects the proposition that, if § 2000e-2(m) does not cover retaliation, such claims are governed by *Price Waterhouse*'s burden-shifting framework, *i.e.*, if the plaintiff shows that discrimination was *a* motivating factor in an adverse employment action, the defendant may escape liability only by showing it would have taken the same action had there been no illegitimate **[***75]** motive. It is wrong to revert to *Price Waterhouse*, the Court says, because the 1991 Civil Rights Act's amendments to Title VII abrogated that decision.

This conclusion defies logic. Before the 1991 amendments, several courts had applied *Price Waterhouse*'s burden-shifting framework to retaliation claims. [8] In the Court's view, Congress designed § 2000e-2(m)'s motivating-factor standard not only to exclude retaliation claims, but also to override, *sub silentio*, Circuit precedent applying the *Price Waterhouse* framework to such claims. And with what did the 1991

Congress replace the *Price Waterhouse* burden-shifting framework? With a but-for causation requirement *Gross* applied to the ADEA 17 years after the 1991 amendments to Title VII. Shut from the Court's sight is a legislative record replete with statements evincing Congress' intent to strengthen antidiscrimination laws and thereby hold employers accountable for **[*2546]** prohibited discrimination. See Civil Rights Act of 1991, § 2, 105 Stat. 1071; House Report Part II, at 18. It is an odd mode of statutory interpretation that divines Congress' aim in 1991 by looking to a decision of this Court, *Gross*, made under a different statute in 2008, while **[***76]** ignoring the overarching purpose of the Congress that enacted the 1991 Civil Rights Act, see *supra*, at ___ - ___, 186 L. Ed. 2d, at 529-530.

8 See *Vislisel* v. *Turnage*, 930 F.2d 9, 9-10 (CA8 1991); *Carter* v. *South Central Bell*, 912 F.2d 832, 843 (CA5 1990); *Williams* v. *Mallinckrodt*, 892 F.2d 75 (CA4 1989) (table).

C

The Court shows little regard for trial judges who must instruct juries in Title VII cases in which plaintiffs allege both status-based discrimination and retaliation. Nor is the Court concerned about the capacity of jurors to follow instructions conforming to today's decision. Causation is a complicated concept to convey to juries in the best of circumstances. Asking jurors to determine liability based on different standards in a single case is virtually certain to sow confusion. That would be tolerable if the governing statute required double standards, but here, for the reasons already stated, it does not.

VI

A

The Court's assertion that the but-for cause requirement it adopts necessarily follows from § 2000e-3(a)'s use of the word "because" fails to convince. Contrary to the Court's suggestion, see *ante*, at ___, 186 L. Ed. 2d, at 514, the word "because" does not inevitably demand but-for causation to the exclusion of all other **[***77]** causation formulations. When more than one factor contributes to a plaintiff's **[**538]** injury, but-for causation is problematic. See, *e.g.*, 1 Restatement (Third) of Torts § 27, Comment *a*, p. 385 (2005) (noting near universal agreement that the but-for standard is inappropriate when multiple sufficient causes exist) (hereinafter Restatement Third); Restatement of Torts § 9, Comment *b*, p. 18 (1934) (legal cause is a cause that is a "substantial factor in bringing about the harm").

When an event is "overdetermined," *i.e.*, when two forces create an injury each alone would be sufficient to cause, modern tort law permits the plaintiff to prevail upon showing that either sufficient condition created the harm. Restatement Third § 27, at 376-377. In contrast, under the Court's approach (which it erroneously calls "textbook tort law," *ante*, at ___, 186 L. Ed. 2d, at 515), a Title VII plaintiff alleging retaliation *cannot* establish liability if her firing was prompted by both legitimate and illegitimate factors. *Ante*, at ___, 186 L. Ed. 2d, at 521-522.

Today's opinion rehashes arguments rightly rejected in *Price Waterhouse*. Concurring in the judgment in that case, Justice O'Connor recognized the disconnect between the standard the dissent advocated, which **[***78]** would have imposed on the plaintiff the burden of showing but-for causation, see 490 U.S., at 282, 286-287, 109 S. Ct. 1775, 104 L. Ed. 2d 268 (KENNEDY, J., dissenting), and the common-law doctrines on which the dissent relied. As Justice O'Connor explained:

> "[I]n the area of tort liability, from whence the dissent's 'but-for' standard of causation is derived, . . . the law has long recognized that in certain 'civil cases' leaving the burden of persuasion on the plaintiff to prove 'but-for' causation would be both unfair and destructive of the deterrent purposes embodied in the concept of duty of care. Thus, in multiple causation cases, where a breach of duty has been established, the common law of torts has long shifted the burden of proof to . . . defendants to prove that their negligent actions were not the 'but-for' cause of the plaintiff's injury." *Id.*, at 263-264, 109 S. Ct. 1775, 104 L. Ed. 2d 268 (concurring in judgment) (citing **[*2547]** *Summers* v. *Tice*, 33 Cal. 2d 80, 84-87, 199 P. 2d 1, 3-4 (1948)).

Justice Brennan's plurality opinion was even less solicitous of the dissent's approach. Noting that, under the

standard embraced by the dissent in *Price Waterhouse*, neither of two sufficient forces would constitute cause even if either one alone would have **[***79]** led to the injury, the plurality remarked: "We need not leave our common sense at the doorstep when we interpret a statute." 490 U.S., at 241, 109 S. Ct. 1775, 104 L. Ed. 2d 268.

B

As the plurality and concurring opinions in *Price Waterhouse* indicate, a strict but-for test is particularly ill suited to employment discrimination cases. Even if the test is appropriate in some tort contexts, "it is an entirely different matter to determine a 'but-for' relation when . . . consider[ing], not physical forces, but the mind-related characteristics that constitute motive." *Gross*, 557 U.S., at 190, 129 S. Ct. 2343, 174 L. Ed. 2d 119 (BREYER, J., dissenting). When assessing an employer's multiple motives, "to apply 'but-for' causation is to engage in a **[**539]** hypothetical inquiry about what would have happened if the employer's thoughts and other circumstances had been different." *Id.*, at 191, 129 S. Ct. 2343, 174 L. Ed. 2d 119. See also *Price Waterhouse*, 490 U.S., at 264, 109 S. Ct. 1775, 104 L. Ed. 2d 268 (opinion of O'Connor, J.) ("'[A]t . . . times the [but-for] test demands the impossible. It challenges the imagination of the trier to probe into a purely fanciful and unknowable state of affairs.'" (quoting Malone, Ruminations on Cause-In-Fact, 9 Stan. L. Rev. 60, 67 (1956))).

This point, lost on the Court, was not lost on Congress. When **[***80]** Title VII was enacted, Congress considered and rejected an amendment that would have placed the word "solely" before "because of [the complainant's] race, color, religion, sex, or national origin." See 110 Cong. Rec. 2728, 13837-13838 (1964). Senator Case, a prime sponsor of Title VII, commented that a "sole cause" standard would render the Act "totally nugatory." *Id.*, at 13837. Life does not shape up that way, the Senator suggested, commenting "[i]f anyone ever had an action that was motivated by a single cause, he is a different kind of animal from any I know of." *Ibid.*

* * *

The Court holds, at odds with a solid line of decisions recognizing that retaliation is inextricably bound up with status-based discrimination, that § 2000e-2(m) excludes retaliation claims. It then reaches outside of Title VII to arrive at an interpretation of "because" that lacks sensitivity to the realities of life at work. In this endeavor, the Court is guided neither by precedent, nor by the aims of legislators who formulated and amended Title VII. Indeed, the Court appears driven by a zeal to reduce the number of retaliation claims filed against employers. See *ante*, at ___ - ___, 186 L. Ed. 2d, at 521-522. Congress had no such goal in **[***81]** mind when it added § 2000e-2(m) to Title VII. See House Report Part II, at 2. Today's misguided judgment, along with the judgment in *Vance* v. *Ball State Univ.*, *post*, p. ___, 133 S. Ct. 2434, 186 L. Ed. 2d 565, should prompt yet another Civil Rights Restoration Act.

For the reasons stated, I would affirm the judgment of the Fifth Circuit.

**REFERENCES**

42 U.S.C.S. §§ 2000e-2, 2000e-3

3 Labor and Employment Law §§ 52.01, 58.01, 58.03, 58.04, 58.14 (Matthew Bender)

L Ed Digest, Civil Rights § 6.8

L Ed Index, Job Discrimination; Retaliation or Revenge

Employer's liability under § 704(a) of Civil Rights Act of 1964 (42 U.S.C.S. § 2000e-3(a), as amended) for retaliating against employee who challenges, or assists in challenge to, alleged unlawful employment practice--Supreme Court cases. 172 L. Ed. 2d 889.

Supreme Court's view as to weight and effect to be given, on subsequent judicial construction, to prior administrative construction of statute. 39 L. Ed. 2d 942.

Racial discrimination in labor and employment--Supreme Court cases. 28 L. Ed. 2d 928.

# TAB 23

**STANLEY C. CRUDEN, PHILIP ZERYLNICK, individually and on behalf of a class of persons similarly situated, and SIBALIN, S.A., a corporation, Plaintiffs-Appellants, v. THE BANK OF NEW YORK, a corporation; IRVING TRUST COMPANY, a corporation; STERLING NATIONAL BANK & TRUST COMPANY OF NEW YORK, a corporation; BANKERS TRUST COMPANY, a corporation; ROCKWOOD NATIONAL CORPORATION, a corporation, and JAMES E. TOWNSEND, an individual, Defendants, THE BANK OF NEW YORK, a corporation; IRVING TRUST COMPANY, a corporation; STERLING NATIONAL BANK & TRUST COMPANY OF NEW YORK, a corporation, and BANKERS TRUST COMPANY, a corporation, Defendants-Appellees. STANLEY C. CRUDEN, Individually and on behalf of a Class of Persons Similarly Situated; PHILIP ZERYLNICK, and SIBALIN, S.A., a corporation, Plaintiffs-Appellants, v. IRVING TRUST COMPANY, a corporation; ROCKWOOD NATIONAL CORPORATION, a corporation; JAMES E. TOWNSEND, an individual; THE BANK OF NEW YORK, a corporation; STERLING NATIONAL BANK & TRUST COMPANY OF NEW YORK, a corporation; BANKERS TRUST COMPANY, Defendants-Appellees**

**Docket Nos. 91-7187, 91-7189, 91-7191, 91-7193, Docket Nos. 91-7041, 91-7047, 91-7053, 91-7065**

**UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT**

**957 F.2d 961; 1992 U.S. App. LEXIS 136; Fed. Sec. L. Rep. (CCH) P96,472**

**May 16, 1991, Argued**
**January 6, 1992, Decided**

**PRIOR HISTORY:** **[**1]** Plaintiffs, debenture holders of a defaulted lender, appeal from four judgments entered against them on January 25 and January 28, 1991 in the United States District Court for the Southern District of New York (Keenan, Judge) in which the district court (1) dismissed upon motions for summary judgment plaintiffs' claims against defendants Rockwood National Corporation and Rockwood's former President James E. Townsend -- alleging fraud, breach of the indenture, successor liability, and RICO violations -- as barred by the statute of limitations, (2) dismissed also upon motions for summary judgment plaintiffs' claims against Indenture Trustees the Bank of New York, Irving Trust Company, and Sterling National Bank & Trust Company of New York -- alleging breach of their indenture obligations -- as both barred by the statute of limitations and barred due to proper reliance on opinions of counsel, and (3) dismissed on the pleadings as barred by the statute of limitations plaintiff's claim against Indenture Trustee Bankers Trust Co. alleging breach of its indenture obligations.

**DISPOSITION:** Affirmed in part, reversed in part, and remanded **[**2]** for further proceedings.

**COUNSEL:** MICHAEL P. MALAKOFF, Pittsburgh, Pennsylvania (Richard A. Finberg, Berger Kapetan Malakoff & Meyers, Pittsburgh, Pennsylvania; Jules Brody, Stull, Stull & Brody, New York, New York, of

counsel), for Plaintiffs-Appellants.

CLIFFORD PETERSON, New York, New York (Robert L. Laufer, Paul, Weiss, Rifkind, Wharton & Garrison, New York, New York, of counsel), for Defendant-Appellee Sterling National Bank & Trust Company of New York.

ALFRED W.J. MARKS, New York, New York (Wallace E.J. Collins, Emmet, Marvin & Martin, New York, New York, of counsel), for Defendants-Appellees The Bank of New York and Irving Trust Company.

DAVID RABINOWITZ, New York, New York (Helen Gavaris, Moses & Singer, New York, New York, of counsel), for Defendant-Appellee Bankers Trust Company.

LINDA H. JOSEPH, Buffalo, New York (Joseph A. Podwika, Mary C. Fitzgerald, Jaeckle, Fleischmann & Mugel, Buffalo, New York, of counsel), for Defendants-Appellees Rockwood National Corporation and James E. Townsend.

**JUDGES:** Before: LUMBARD and CARDAMONE, Circuit Judges, and LASKER, District Judge *

> * Hon. Morris E. Lasker, Senior Judge, United States District Court for the Southern District of New York, sitting by designation.

**[**3]**

**OPINION BY:** CARDAMONE

**OPINION**

**[*963]** CARDAMONE, *Circuit Judge:*

Plaintiffs, debenture holders of a defaulted lender, appeal from January 25 and January 28, 1991 judgments of the United States District Court for the Southern District of New York (Keenan, J.) which granted summary judgment dismissing on various grounds, plaintiffs' claims against the successor of the debentures' issuer or guarantor and the Indenture Trustees. The district court's ruling covered four separate **[*964]** actions arising from the same set of facts. In each, the debenture holders are suing (1) Rockwood National Corporation claiming it is liable -- as successor to the issuer or guarantor, Levin-Townsend Computer Corporation (Levin-Townsend) -- for payment obligations of debentures, (2) James E. Townsend, a former President of Rockwood National, and (3) the four banks who acted as Indenture Trustees for the four sets of debentures involved. Three actions brought by Stanley Cruden and Philip Zerylnick were certified as class actions pursuant to Fed. R. Civ. P. 23(b)(3), with Cruden and Zerylnick representing a class of individual debenture holders (the Cruden actions). The fourth action was brought by Sibalin, S.A., a Panamanian corporation **[**4]** with its principal place of business in Geneva, Switzerland, and a debenture holder (the Sibalin action). The Sibalin action involves substantially the same claims against the same defendants, but raises some distinct issues and consequently will be referred to separately when necessary.

This opinion is necessarily long because the numerous clauses of the Indentures and the Trust Indenture Act upon which the multiple parties' rights hinge must be set forth to make this appeal intelligible. But its length should not deter the reader because -- just as the daunting facade in the Wizard of Oz was stripped away revealing an ordinary man manually operating a wind machine, so here -- after all the facts have been exposed what remains to be decided are two rather straightforward legal questions: whether the statute of limitations bars plaintiffs' claims against all defendants and whether defendant Trustees properly relied on the opinion of counsel. For the reasons discussed below, the judgments of the district court a affirmed, in part, reversed in part, and remanded.

FACTS

In the late 1960's, Levin-Townsend, a New Jersey corporation, raised capital by entering into a series of Trust Indentures **[**5]** under which it or its subsidiary, Levin-Townsend International, Inc. (International), issued debentures to the public. The Cruden plaintiffs are holders of $ 2,349,600 in debentures issued by Levin-Townsend. Sibalin owns $ 266,000 worth of debentures issued by International. Although International was the obligor on this bond issue, payment was unconditionally guaranteed by Levin-Townsend.

Defendant Bank of New York is the Indenture Trustee for one series of these debentures designated as 5 1/4 percent Convertible Subordinated Debentures. Defendant Sterling National Bank & Trust Co. of New York (Sterling) is the Indenture Trustee for a series designated as 7 percent Convertible Senior Subordinated

Debentures. Defendant Irving Trust Co. (Irving) is the Indenture Trustee for debentures designated as 5 1/2 percent Convertible Subordinated Debentures. Defendant Bankers Trust Co. (Bankers Trust) is the Indenture Trustee for the International bond issue, debentures designated as 5 percent Guaranteed Convertible Debentures. The Indenture Agreements for the Irving and the Bank of New York issues were entered into on April 15 and September 15, 1967, respectively. The Indenture Agreements **[**6]** for the Sterling and Bankers Trust issues were entered into on August 1, 1968. Chase Manhattan Bank originally was a party to the Sterling Indenture Agreement and was succeeded by Sterling on September 24, 1971. Each Indenture Agreement was made with Levin-Townsend, and each of the debentures was convertible into common stock of Levin-Townsend. Interest was due semi-annually over the 15 to 20 year life of the debentures. Principal was due as to the Sterling issue on August 1, 1983, and as to the other issues thereafter.

Beginning in July 1972, a series of events took place that are the centerpiece of the instant dispute. First, Levin-Townsend changed its name to Rockwood Computer Corporation (still referred to for convenience as Levin-Townsend). Second, Levin-Townsend formed two Delaware corporations: Rockwood Computer Corporation (Computer), and Rockwood National Corporation (National). Third, on August 8, 1973 pursuant to terms of an Agreement and Plan of Reorganization, Computer became a wholly-owned subsidiary of National, **[*965]** Levin-Townsend transferred substantially all of its assets to Computer, and Computer assumed all Levin-Townsend's debts. Further, National became the 100 percent **[**7]** stockholder of Computer, and Levin-Townsend shareholders received shares in National on a one-for-one basis, with no new shareholders being added.

National and Computer thereafter entered into Supplemental Indenture Agreements with each of the defendant Trustees in which the conversion and payment/guarantee obligations described in the original Indentures were split. Computer agreed to assume the obligation of paying principal and interest on the debentures issued by Levin-Townsend and to assume the role of guarantor as to the International issue; National agreed to permit the conversion of the debentures into its stock. Immediately after the August 8, 1973 reorganization was consummated, Computer's 86 percent-owned real estate subsidiary, National Equities, Inc. (NEI), was transferred to National, in exchange for a $ 40,946,638 non-interest-bearing promissory note. This note was never paid.

In 1976, Computer, its subsidiary International (formerly the subsidiary of Levin-Townsend), and NEI went into default for nonpayment of interest on various of the debentures. These defaults were cured by an Exchange Offer in 1978 orchestrated by National in which 73 percent of the total outstanding **[**8]** debentures of Computer, International and NEI were tendered. National offered cash and its own convertible income debentures due January 1993 in exchange for the debentures of these three companies, and all back interest due on the debentures not exchanged was paid in full.

On March 16, 1979 the original purchase price for the NEI stock was reduced from $ 41 to $ 7.8 million. Then, an extremely peculiar transaction took place that resulted in this debt being erased. National sold to Computer the stock of Rockwood Leasing Services, Inc. The assets of Rockwood Leasing consisted of $ 23.2 million in principal amount of *Computer debentures* obtained in the above Exchange Offer and a promissory note of Computer in the amount of $ 600,000. Thus, the $ 41 million note for National's purchase of NEI was initially deferred, then written down by 80 percent, and ultimately exchanged for Computer's own securities, which National had obtained with funds originating from Computer.

In August 1983 Computer and International defaulted on the payment of principal and interest on the Sterling and Bankers Trust issues, respectively. This forced Computer to file a voluntary bankruptcy petition, which **[**9]** constituted a default under the Indentures. All other debenture series shortly thereafter went into default.

PROCEDURAL HISTORY

In June 1985 the Cruden plaintiffs filed three lawsuits in the Southern District of New York. The actions were certified as class actions on February 1, 1988. Sibalin filed its suit in July 1987. All plaintiffs are suing the Trustees for violations of the Trust Indenture Act of 1939, 15 U.S.C. § 77aaa *et seq.* (1988), and for breach of the Indentures. They also assert causes of action against National and Townsend for breach of the Indentures, piercing the corporate veil, common law

fraud, violations of the New York Fraudulent Conveyance Act, N.Y. Debt. & Cred. § 270-281 (McKinney 1991), and for violations of the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. § 1961 *et seq.* (1988) (RICO).

Plaintiffs claim that the 1972 reorganization was part of a fraudulent scheme to siphon profits from Computer to National, leaving Computer unable to meet its obligations on the bonds and that National dominated and controlled Computer through common officers and directors to achieve these illicit ends. Plaintiffs allege, for example, that defendants **[**10]** National and Townsend committed fraud through self-dealing over the six-year period from 1972-1979 during which time the $ 41 million non-interest-bearing promissory note given to Computer by National for the purchase of NEI was delayed, written down, and finally cancelled. They also argue that the degree of National's domination over Computer **[*966]** during this period justifies piercing the corporate veil.

Plaintiffs further allege that the 1972 reorganization of Levin-Townsend constituted a consolidation, merger, or sale or transfer of all or substantially all of its assets under the original Indentures and, as such, the reorganization was required to satisfy certain conditions under the Indentures, *i.e.,* that Levin-Townsend's obligation to pay principal and interest, or in the case of the Bankers Trust issue, to act as guarantor, pursuant to the terms of the debentures be assumed by both National *and* Computer. Because the conversion and payment/guarantee obligations were, in fact, split, plaintiffs allege that the Supplemental Indentures violated each of the original Indentures and the Trustees therefore breached the Indentures by agreeing to the Supplemental Indentures. Plaintiffs **[**11]** also allege that the defendant Trustees violated the original Indentures and failed to protect debenture holders by relying upon, and negligently failing to examine, opinions of counsel issued by Simpson Thacher & Bartlett, Esqs., which stated that the above reorganization and Supplemental Indentures complied with the Indentures. In addition they contend that these opinions failed to comply with the Indentures for several reasons.

National and Townsend filed motions for summary judgment in all four actions, asserting, *inter alia,* the statute of limitations barred the claims against them. Defendants Sterling, Irving, and Bank of New York also moved for summary judgment based on the statute of limitations, and alternatively asserted their good faith reliance on opinions of counsel in executing the Supplemental Indentures precluded liability. Bankers Trust sought judgment on the pleadings, arguing only a statute of limitations defense. All plaintiffs thereafter cross-moved for summary judgment on the issue of liability. Sibalin's motions as to National and Townsend were later withdrawn.

In an opinion dated September 4, 1990, Judge Keenan granted defendants' motions in part. *See* **[**12]** 1990Fed. Sec. L. Rep. para. 95,466 (S.D.N.Y. 1990). He ruled that the suits against the Trustees were governed by New York's six-year statute of limitations for breach of contract actions which he held began to run at the time of the alleged breach. Thus, the court dismissed all claims against the Trustees that accrued prior to the following dates:

| Defendant Trustee | Allegations viable as of |
|---|---|
| | |
| Bank of New York | June 3, 1979 |
| | |
| Sterling | June 5, 1979 |
| | |
| Irving | June 12, 1979 |
| | |
| Bankers Trust | July 30, 1981 |

This dismissal effectively covered all plaintiffs' claims based on the Trustees' alleged pre-bankruptcy misconduct. Alternatively, the district court found that Sterling, Irving and Bank of New York had properly relied on the Simpson, Thacher opinions and were thus absolved of all potential liability for the alleged breaches.

The district court also dismissed the complaints with prejudice as against National and Townsend. It found the circumstances appropriate to disregard the corporate form in order to achieve equity, and that the evidence submitted weighed in favor of finding successor liability. Nevertheless, the trial court went on to find that plaintiffs' claims **[**13]** for successor liability, piercing the corporate veil, and breach of the Indentures were all based on *fraud* and, under the accrual rules for fraud claims, were time-barred. It ruled that the RICO and fraud claims were untimely for the same reasons. The Cruden plaintiffs' cross-motions for summary judgment on the issue of liability were therefore denied.

The district court's judgment did not affect plaintiffs' claims based on defendants' post-bankruptcy conduct, but those claims were subsequently dismissed by the district court at plaintiffs' request. Final judgments were entered accordingly on January 25 and 28, 1991.

DISCUSSION

I Claims Against The Trustees

A. *Statute of Limitations*

Defendants Bank of New York, Sterling, and Irving moved for summary judgment, and defendant Bankers Trust moved to dismiss on the pleadings based on **[*967]** statute of limitations grounds. The district court held that actions against the Indenture Trustees were time-barred. Because the Trust Indenture Act does not include a statute of limitations, the court borrowed a six-year statute of limitations for breach of contract actions from New York law. *See* N.Y. Civ. Prac. L. & R. § 213(2) (McKinney 1991). **[**14]** The district court then dismissed as time-barred plaintiffs' amended complaints insofar as they related to culpable conduct by Bank of New York, Sterling, and Irving before the summer of 1979 and by Bankers Trust before the summer of 1981. We think in reaching this conclusion the district court erred.

As an initial matter, the Trustees argue that we should adopt a uniform federal statute of limitations for actions arising under the Trust Indenture Act. They contend that our opinion in *Ceres Partners v. GEL Assoc.,* 918 F.2d 349, 360 (2d Cir. 1990), in which we joined the Third and Seventh circuits in abandoning the long-standing practice of borrowing analogous state statutes of limitations for actions brought under §§ 10(b) and 14 of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78j(b), 78n (1988), supports their view that we should not look to state statutes. Instead, the Trustees urge us to borrow the one-year, three-year limitation of § 77www(a) of the Trust Indenture Act, which creates a cause of action for misleading statements filed with the SEC. This provision bars actions not brought within one year of discovery and three years after the cause of action **[**15]** accrued, and is found throughout the federal securities laws. *See, e.g.,* 15 U.S.C. § 78i(e) (manipulation of securities prices); 15 U.S.C. § 78r(c) (liability for misleading statements in SEC filings); 15 U.S.C. § 78cc(b) (voidable illegal contracts). The plaintiffs here allege both breach of the Trust Indenture Act, a statutory claim, and breach of the Indentures, which are contract claims. Each of the Indentures specifically provides: "This Indenture and each Debenture shall be deemed to be a contract made under the laws of the State of New York, and for all purposes shall be construed in accordance with the laws of said State." Thus, even were we to adopt a uniform federal rule for the federal statutory cause of action, New York's six-year statute of limitations for" contract claims would still apply to the state causes of action. *See H. Sand & Co., Inc. v. Airtemp Corp.,* 934 F.2d 450 (2d Cir. 1991) (contract must be construed under applicable state law including state statute of limitations); *see also Rogers v. Grimaldi,* 875 F.2d 994, 1002, 10 U.S.P.Q.2D (BNA) 1825 (2d Cir. 1989).

Because the two causes of action are so intertwined, it appears prudent **[**16]** in this case to continue to borrow state statutes of limitations for suits arising out of indenture agreements. For the same reason, we need not decide whether the Trust Indenture Act is applicable to the debentures issued by International, which were traded in the European market. For purposes of this appeal, Sibalin's claim against Bankers Trust for violations of its Indenture can be regarded as contractual in nature only, and we refer to provisions of the Trust Indenture Act merely for illumination. We agree therefore with Judge Keenan's decision to apply New York's six-year statute of limitations both to plaintiffs' statutory and/or contract

claims against the Trustees. The pivotal question we must address is when that limitations period began to run in these cases. Central to this question are the so-called "no action" clauses contained in each Indenture.

B. *The "No Action" Clause*

All four of the Indentures contain what are known as "no action" clauses. The Sterling Indenture is typical:

*No holder of any Debenture shall have any right* by virtue or by availing of any provision of this Indenture *to institute any action* or proceedings at law or in equity or in bankruptcy **[**17]** or otherwise, *upon or under or with respect to this Indenture, or for the appointment of a receiver or trustee, or for any other remedy hereunder, unless* such holder previously shall have given to the Trustee written notice of default and of the continuance thereof, as hereinbefore provided, *and unless also* the holders of not less than twenty-five per **[*968]** cent in aggregate principal amount of the Debentures then outstanding shall have made written request upon the Trustee to institute such action or proceedings in its own name as Trustee hereunder and shall have offered to the Trustee such reasonable indemnity as it may require against the costs, expenses and liabilities to be incurred therein or thereby, *and* the Trustee for thirty days after its receipt of such notice, request and offer of indemnity shall have failed to institute any such action or proceedings . . . .

Sterling Indenture at § 9.04 (emphasis added). These clauses are strictly construed. *See Friedman v. Chesapeake & Ohio Ry. Co.,* 261 F. Supp. 728, 730 n.1 (S.D.N.Y. 1966) ("The quoted reference is definite and fairly places the bondholder on notice that his rights . . . are restricted and **[**18]** conditioned by the indenture."), *aff'd,* 395 F.2d 663 (2d Cir. 1968), *cert. denied,* 393 U.S. 1016, 21 L. Ed. 2d 561, 89 S. Ct. 619 (1969).

Notwithstanding the "no action" clause, the debenture holders have an absolute right to institute suit *after* non-payment of principal or interest:

Notwithstanding any other provisions of this Indenture, however, *the right of any holder of any Debenture* to receive payment of the principal of (and premium, if any) and interest on such Debenture, on or after the respective due dates expressed in such Debenture, or *to institute suit for the enforcement of any such payment on or after such respective [due] dates, shall not be impaired or affected without the consent of such holder . . .*

Sterling Indenture at § 9.04 (emphasis added). This provision, required by § 316 of the Trust Indenture Act, 15 U.S.C. § 77ppp(b), is contained in all four of the Indentures.

Hence, by the terms of the Indentures, the debenture holders could not bring suit "upon or with respect to" the Indenture until either (a) there was an "event of default" -- defined as including nonpayment of interest or principal, breach of the Indenture, or bankruptcy of the **[**19]** issuer -- *and* the debenture holders gave written notice of that event to the Trustee, *and* at least 25 percent in aggregate principal amount of debenture holders made a request of the Trustee to institute suit, *and* the holders offered the Trustee indemnity, *and* 30 days (or 60 days depending on the Indenture) had passed without the Trustee instituting suit, *or* (b) the issuer defaulted on payment of principal or interest. Because the claims against the Trustees are not for non-payment of principal or interest as such, but rather assert breaches of the Trust Indenture Act and the Indentures, alternative (b) is irrelevant in assessing when plaintiffs' causes of action against the Trustees accrued.

The district court held that the "no action" clause applied only to debenture holder suits against Levin-Townsend, not the Indenture Trustees. 1990Fed. Sec. L. Rep. para. 95,466 at 97,413. This construction of § 9.04 obviously is correct, as it would be absurd to require the debenture holders to ask the Trustee to sue itself. Nonetheless, merely because the "no action" clause does not by its terms prohibit suit against the Trustees for breach of their obligations **[**20]** under the Indentures does not mean that it did not operate to toll the statute of limitations upon an alleged breach having occurred. Plaintiffs' causes of action against the Trustees cannot be deemed to have *accrued* until the plaintiffs were entitled to a remedy, regardless of when the Trustees actually breached the Indentures, which, plaintiffs allege, occurred when the Trustees entered into the Supplemental Indentures.

Had the debenture holders sued the Trustees in 1973 when the latter executed the Supplemental Indentures, they would have had no remedy. Damages could not have been ascertained in 1973 since there was no default on principal or interest payments until 1983. Nor could the court in 1973 have fashioned equitable relief, such as

rescission or reformation, without joining the issuer as an indispensable party within the meaning of Fed. R. Civ. P. 19(a)(2)(i), because the issuer properly would have "claimed an interest relating **[*969]** to the subject of the action and [would have been] so situated that the disposition of the action in [its] absence . . . as a practical matter [would have] impaired or impeded its ability to protect that interest." Although the issuer conceivably **[**21]** could have been joined by the Indenture Trustees as a third party defendant under Fed. R. Civ. P. 14(a), such a joinder would have allowed the debenture holders to circumvent the "no action" clauses, upsetting settled indenture law and the expectations of countless parties to proposed or existing indenture agreements, a course we believe would have been unwise if taken then, and equally unwise today. Consequently, plaintiffs had no remedy until 1983 when there was a default in payment. Only then did plaintiffs' causes of action against the Trustees accrue. Therefore, plaintiffs' suits against the Indenture Trustees -- brought well within six years of the 1983 default -- are not barred by the six-year New York statute of limitations applicable to these claims and the district court erred when it concluded otherwise.

Because Bankers Trust relied solely on its argument that Sibalin's claim was untimely, the judgment entered in favor of Bankers Trust is reversed and the cause is remanded for further proceedings. Bank of New York, Sterling and Irving, however, additionally asserted the defense of proper reliance on opinion of counsel. Having concluded that the Cruden plaintiffs' claims **[**22]** against these defendants are timely, we now turn to address the question of whether they are nonetheless barred because of the Trustees' reliance on the Simpson, Thacher opinion. The following discussion therefore bears directly only on the Cruden plaintiffs' claims against Bank of New York, Sterling and Irving.

C. *Opinions of Counsel*

The Indenture Agreements governing the debenture issues required the issuer and the Indenture Trustees to enter into Supplemental Indentures upon the reorganization of Levin-Townsend. Pursuant to the Indentures, each of the Indenture Trustees obtained opinions of counsel from Simpson, Thacher dated August 8, 1973. The Cruden plaintiffs contend that the Simpson, Thacher opinions do not conform to the requirements of the Indentures, and hence reliance by Bank of New York, Sterling, and Irving upon those opinions cannot be asserted as a defense to liability for breach of the Indentures or the Trust Indenture Act. We disagree.

Under the Trust Indenture Act (Act), an indenture may provide that prior to default (as defined in the indenture):

the indenture trustee may *conclusively rely,* as to the truth of the statements and the correctness of the **[**23]** opinions expressed therein in the absence of bad faith on the part of such trustee, upon certificates or opinions conforming to the requirements of the indenture.

15 U.S.C. § 77ooo(a)(2) (1988) (emphasis added). The Sterling Indenture, like the Bank of New York and Irving Indentures, contains the type of provision permitted by § 77ooo(a)(2):

in the absence of bad faith on the part of the Trustee, the Trustee may *conclusively rely,* as to the truth of the statements and the correctness of the opinions expressed therein, upon any certificates or opinions furnished to the Trustee and conforming to the requirements of this Indenture; but in the case of any such certificates or opinions which by any provision hereof are specifically required to be furnished to the Trustee, the Trustee shall be under a duty to examine the same to determine whether or not they conform to the requirements of this Indenture.

Sterling Indenture at § 10.01(a)(2) (emphasis added). [1] In order to "conform to the **[*970]** requirements of [the] Indenture," an opinion of counsel must be

an opinion in writing signed by legal counsel, who shall be acceptable to the Trustee and who may, unless in a particular instance **[**24]** the Trustee shall otherwise require, be of counsel to the Company. Each such opinion shall include the statements provided for in Section 17.04, if and to the extent required by the provisions thereof.

*Id.* at § 1.01. The "statements provided for in Section 17.04" are required by § 77nnn(e) of the Act, and hence appear in the Sterling, Bank of New York, and Irving Indentures. They are:

1. a statement that the person making such certificate or opinion has read such covenant or condition;

2. a brief statement as to the nature and scope of the examination or investigation upon which the statements

or opinions contained in such certificate or opinion are based;

3. a statement that, in the opinion of such person, he has made such examination or investigation as is necessary to enable him to express an informed opinion as to whether or not such covenant or condition has been complied with; and

4. a statement as to whether or not, in the opinion of such person, such condition or covenant has been complied with.

1 § 77ooo was amended in 1990. *See* Pub. L. 101-550, Title IV, § 414, Nov. 15, 1990, 104 Stat. 2730. A provision in an indenture allowing a trustee to conclusively rely on an opinion of counsel now is automatically deemed to be provided for in an indenture, unless the indenture expressly excludes such a provision. 15 U.S.C. § 77ooo(a) (1990).

**[**25]** Plaintiffs assert that the second requirement was not satisfied because the nature and scope of Simpson, Thacher's examination were simply not stated. In addition, they contend the fourth requirement was not met because counsel's opinions failed to address the issues of debenture holder approval for the reorganization and the separation of the conversion and payment obligations between National and Computer, respectively. We address these contentions in turn.

First, the Simpson, Thacher opinions contained the requisite statement describing the nature and scope of the examination or investigation. The letter to Sterling is typical. In pertinent part it stated

we have examined the Agreement and Plan of Reorganization, the Indenture and the Supplemental Indenture, and . . . such other documents, corporate records and certificates and such questions of law as we have considered necessary or appropriate . . . .

Counsel's letter continued

we are of the opinion that we have made such examination or investigation as is necessary to enable us to express an informed opinion as to the matters set forth below.

Although these statements were brief, Simpson, Thacher advised that it had **[**26]** made the examination or investigation it believed necessary to render a legal opinion in this matter. These statements satisfied the first three requirements of the relevant sections of the Indentures and § 77nnn(e) of the Act.

Plaintiffs also urge that Simpson, Thacher should have passed on whether a debenture holder vote was required by § 13.02 of the Sterling Indenture (and analogous provisions in the Bank of New York and Irving Indentures). Close examination reveals that there is less to this argument than at first appears.

It is conceded that the 1973 Supplemental Indenture is governed by Article 14 of the Sterling Indenture (and similar provisions in the Bank of New York and Irving Indentures) titled "Consolidation, Merger, Sale or Transfer." That Article provides

Subject to the provisions of Section 4.05, nothing contained in this Indenture or in any of the Debentures shall prevent any consolidation or merger of the Company with or into any other corporation or corporations or successive consolidations or mergers in which the Company or its successor or successors shall be a party or parties, or shall prevent any sale or transfer of all or substantially all of the assets of **[**27]** the Company to any other corporation authorized to acquire and operate the same . . . .

Sterling Indenture at § 14.01. Section 4.05 simply states that in case of a consolidation, merger, or sale of the Company, the Company or its successor shall execute a supplemental indenture providing the debenture **[*971]** holders with the right to convert their debentures into "the kind and amount of shares of stock" such holders could have converted their debentures into prior to the merger, sale, or consolidation. This provision is obviously designed to protect debenture holder conversion rights.

The supplemental indenture required by §§ 14.01 and 4.05 is explicitly provided for by, *e.g.,* Article 13 of the Sterling Indenture. There are two possible ways the Company may enter into supplemental indentures pursuant to that Article. The first explicitly allows the Trustee to enter into supplemental indentures without debenture holder approval:

*The Company,* when authorized by a resolution of its Board of Directors, *and the Trustee may* from time to time and at any time *enter into an indenture* or indentures *supplemental hereto* (which shall conform to the

provisions of the Trust Indenture **[**28]** Act of 1939 as in force at the date of the execution thereof) for one or more of the following purposes:

(a) to evidence the succession of another corporation to the Company, or successive successions, and the assumption by the successor corporation of the covenants, agreements and obligations of the Company *pursuant to Article Fourteen hereof;*

(b) to provide for the adjustment of conversion rights of Debenture pursuant to the requirements of Section 4.05;

. . . .

Any supplemental indenture authorized by the provisions of this section 13.01 may be executed by the Company and the Trustee *without the consent of the holders of any of the Debentures* at the time outstanding, notwithstanding any of the provisions of Section 13.02.

Sterling Indenture at § 13.01 (emphasis added). Alternatively,

*with the consent of the holders of not less than sixty-six and two-thirds percent (66 2/3%) in aggregate principal amount of the Debentures at the time outstanding, the Company,* when authorized by a resolution of its Board of Directors, *and the Trustee may . . . enter into an indenture or indentures supplemental hereto* . . . for the purpose of . . . modifying in any manner the **[**29]** rights of the holders of the Debentures; *provided however,* that no such supplemental indentures shall . . . alter or impair the right to convert the [Debentures] into Common Stock at the price and upon the terms provided in this Indenture, without the consent of the holder of each Debenture so affected . . . .

*Id.* at § 13.02 (emphasis added).

Plaintiffs argue the Simpson, Thacher letters were required to address and state whether § 13.02 had been complied with. Counsel's letter to Sterling notes that "the Supplemental Indenture complies with Sections 4.05 and 14.01 of the Indenture, and the covenants of the Predecessor Company contained in Sections 4.05 and 14.01 of the Indenture have been complied with." It states further that "the Supplemental Indenture does not . . . conflict with or result in a breach of the terms, conditions or provisions of . . . any . . . indenture . . . known to us to which the Company or National is a party or by which it is bound." By clear implication, Simpson, Thacher found the Supplemental Indenture was properly entered into pursuant to § 13.01 that (a) allows for such an undertaking (as described in § 14.01), and (b) allows such an undertaking **[**30]** without debenture holder approval. Thus, because it concluded the Supplemental Indenture did not require debenture holder approval and was therefore governed by § 13.01, there was no need for counsel to discuss § 13.02 in its letter.

It is next asserted that the Trustees' reliance on the Simpson, Thacher opinions was unwarranted because the opinions failed to address § 17.02 of the Sterling Indenture. Section 17.02 (and similar provisions in the Bank of New York and Irving Indentures) sets forth that the Indenture binds Levin-Towsend's successors and assigns: "All the covenants, stipulations, promises and agreements in this Indenture contained by or in behalf of the Company shall bind its successors and assigns, whether so expressed or not. **[*972]** " There are no covenants to be complied with in this section. The provision operates "whether so expressed or not" in the Supplemental Indentures. An opinion of counsel, on the other hand, need only address "compliance with a *condition or covenant* provided for in [the] Indenture." Thus, omission of any reference to § 17.02 did not render the opinions of counsel unworthy of reliance.

Similarly meritless is the insistence that Simpson, Thacher **[**31]** failed to address the requirement in § 4.01 of all three Indentures that Levin-Townsend's successor honor the debenture holders' conversion rights. A review of § 4.01 of the Indentures shows that such a provision does not exist. Rather, it is § 4.05 that addresses conversion rights in the event of the merger, consolidation or sale of Levin-Townsend. As already discussed, the Simpson, Thacher opinions specifically note that § 4.05 has been complied with.

Consequently, the opinions conform to the requirements in the Indentures. Although the plaintiffs also maintain there is a lack of evidence that the Trustees examined and relied upon the opinions in good faith, there is no evidence in the record to support such an assertion. A genuine issue of fact requiring a trial cannot be raised by arguments or statements unsupported by sworn statements by persons with personal knowledge. *See Beyah v. Coughlin,* 789 F.2d 986, 989-90 (2d Cir. 1986). Judge Keenan observed that there was a studied

approach to the opinions, and that the Trustees and Simpson, Thacher corresponded about them, reflecting discussion and work between them.

For these reasons, the district court properly **[**32]** granted summary judgment in favor of defendants Sterling, the Bank of New York, and Irving because of their good faith reliance can opinions of counsel.

D. *Attorney Client Privilege*

Discovery in the trial court was limited to the Trustees' reliance on the opinions of Simpson, Thacher. Discovery was not permitted with respect to advice of the Trustees' in-house and retained counsel. Plaintiffs claim that they should have been able to discover all legal advice on which the Trustees relied to ascertain whether they reasonably relied in good faith on the Simpson, Thacher opinions.

A trial court enjoys wide discretion in its handling of pre-trial discovery, and its rulings with regard to discovery are reversed only upon a clear showing of an abuse of discretion. *See Robertson v. National Basketball Ass'n,* 622 F.2d 34, 35-36 (2d Cir. 1980); *Lehigh Valley Indus., Inc. v. Birenbaum,* 527 F.2d 87, 93 (2d Cir. 1975). While the Trustees arguably waived the attorney-client privilege by asserting their good faith defense, the district court's ruling was not an abuse of discretion. Assertion of this defense waived the privilege regarding only the advice **[**33]** of Simpson Thacher, upon which the Trustees claimed reliance. Because the Trustees did not put forth the opinions of their in-house or retained counsel as a defense, plaintiffs' request for further discovery concerning such advice was properly denied.

II Claims Against Rockwood National and Townsend

Both Sibalin's and the Cruden plaintiffs' complaints allege claims against Rockwood National and Townsend on several grounds: COUNT III against National, as **[*973]** successor, for breach of the Indenture; COUNT IV against National, as successor, for payment of principal and interest; COUNT V against National for fraud; COUNT VI against Townsend for fraud based on self-dealing; COUNTS VII and VIII against Townsend and National for RICO violations; COUNT IX against National for piercing the corporate veil based on fraud. National and Townsend, in their summary judgment motions, argued, *inter alia,* that these claims were barred by the statute of limitations.

The district court ruled that all of plaintiffs' claims were time-barred. It (a) calculated the accrual date for statute of limitations purposes as to the fraud claims from the date of certain allegedly fraudulent transfers from Computer **[**34]** to National occurring during the 1970's, (b) held that the causes of action for breach of the Indenture accrued when the Supplemental Indentures were executed in 1973, (c) held that plaintiffs' piercing the corporate veil and successor liability claims were based on the fraudulent transfers, and (d) dismissed plaintiffs' RICO claims as time-barred based upon our holding in *Bankers Trust Co. v. Rhoades,* 859 F.2d 1096 (2d Cir. 1988), *certs. denied,* 490 U.S. 1007, 109 S. Ct. 1643, 104 L. Ed. 2d 158 (1989). We discuss each of these rulings in turn.

A. *Fraud Claims Against National & Townsend*

The first challenge is to the dismissal of the fraud claims against National and Townsend (Counts V & VI). We think New York law was correctly applied. The statute of limitations for fraud in New York is the longer of either six years from when the cause of action accrued or two years from the time plaintiff discovered the fraud or could have with reasonable diligence discovered it. N.Y. Civ. Prac. L. & R. §§ 203(f), 213(8) (McKinney 1991); *see also Stull v. Bayard,* 561 F.2d 429, 432 (2d Cir. 1977), *cert. denied,* 434 U.S. 1035, 54 L. Ed. 2d 783, 98 S. Ct. 769 (1978); *Quadrozzi Concrete Corp. v. Mastroianni,* 56 AD2d 353, 355-56, 392 N.Y.S.2d 687 **[**35]** (2d Dep't 1977).

To determine when the fraud was or should have been discovered, New York courts apply an objective test. If the circumstances of the alleged fraud would "suggest to a person of ordinary intelligence the probability that he has been defrauded, a duty of inquiry arises. . . ." *Armstrong v. McAlpin,* 699 F.2d 79, 88 (2d Cir. 1983) (quoting *Higgins v. Crouse,* 147 N.Y. 411, 416, 42 N.E. 6 (1895)). When a plaintiff "shuts his eyes to the facts which call for investigation, knowledge of the fraud will be imputed to him." *Id.*

The following fraudulent transactions are here alleged to have occurred:

1) the August 8, 1973 reorganization;

2) The August 8, 1973 purchase by National from

Computer of 86 percent of the outstanding stock of NEI for a $ 41 million Note;

3) The 1978 Exchange Offer;

4) The 1979 downward adjustment to the 1973 purchase price of NEI stock from $ 41 million to $ 7 million, which was completed on March 16, 1979. [Joint Appendix at 493a].

There was ample evidence that all plaintiffs had actual or constructive notice of each of these events.

1. Notice to the Cruden Plaintiffs

The terms of the 1973 Reorganization were disclosed **[**36]** on the 10-K forms of Computer and National for the years 1973-76 and in the following: the Exchange Offer Prospectus dated July 13, 1977; a letter sent to debenture holders dated June 27, 1973; a notice to debenture holders dated August 1973; a letter sent to debenture holders dated August 1, 1979; and various newspaper articles. The terms of the sale of Computer's NEI stock to National in August 1973 were disclosed in the Form 10-K's of Computer and National for the same years and in the 1977 Exchange Offer Prospectus. The NEI stock sale was also described in the August 1, 1979 letter from Computer to debenture holders.

The Exchange Offer terms were set forth in the Exchange Offer Prospectus and in the Form 10-K's of Computer and National for the years 1977-1979. In addition, **[*974]** the terms of the Exchange Offer were described in a July 14, 1977 article in *The Wall Street Journal* and a November 1, 1977 article in the *New York Times.* The 1979 reduction of the purchase price of NEI stock was described in National's Form 10-K for 1979 and the August 1, 1979 letter. In addition, Computer had entirely written off the $ 41 million promissory note from its publicly disclosed financial **[**37]** statements, stating that it was uncollectible.

2. Notice to Sibalin

Because Sibalin's debentures were in bearer rather than registered form, Sibalin did not receive the 1973 letter and notice concerning the reorganization, nor did it receive the 1979 letter disclosing the reduction of the purchase price of NEI stock. Notice as to the debentures Sibalin held must be made, according to the Bankers Trust Indenture, by legal publication in three newspapers of general circulation in London, Brussels and New York.

Sibalin concedes that the first notice it received that a wrong may have been committed arose when its interest payments stopped in 1976. Further, notice was given of Computer's default five times in the period from January 1976 until April 1978 in *The Wall Street Journal, The Financial Times, The Luxembourg Wort, Finanz and Wirtschaft,* and *Agence Economique Et Financiere.* These disclosures were in addition to the public filings by National and Computer.

3. Accrual

Despite this overwhelming evidence that all plaintiffs knew of the alleged fraud more than two years prior to filing suit, they assert that their fraud claims are timely. Plaintiffs contend that, because they **[**38]** were not injured by the alleged fraud until 1983 when Computer and International defaulted on payments of debenture interest and principal, they are entitled to have the statute tolled until that time. The alternative six-year period begins to run not upon a plaintiff's having suffered an "injury" as that term seems to be used by plaintiffs, but when a plaintiff suffers a loss as a result of the defendant's fraudulent act. *See Stull,* 561 F.2d at 432. One suffers a "loss" so as to trigger this six-year period "when a plaintiff with assumed knowledge of the fraudulent wrong may assert a claim for relief." *Id.* And although, as discussed below, the plaintiffs could not have asserted a claim for relief against the issuer for breach of the debentures' payment obligations until default, they could have sued (as per the "no action clause") for appropriate legal or equitable relief for the tort of fraudulent conveyance.

New York law provides, "Where a conveyance made or obligation incurred is fraudulent as to a creditor whose claim has not matured he may proceed in a court of competent jurisdiction against any person whom he could have proceeded had his claim matured. **[**39]** . . ." N.Y. Debt. & Cred. § 279 (McKinney 1991). A debenture holder is not required to stand by helplessly until a distant maturity date arrives while his debtor is fraudulently depleted of all its assets. *See In re Assoc. Gas & Elec. Co.,* 61 F. Supp. 11, 44 n.3 (S.D.N.Y. 1944), *aff'd,* 149 F.2d 996 (2d Cir.) (A. Hand, J.), *certs. denied sub nom. Elias v. Clarke et al.,* 326 U.S. 736, 90 L. Ed. 439, 66 S. Ct. 45 (1945); *cf. Ettlinger v. Persian Rug & Carpet Co.,* 142 N.Y. 189, 192-93, 36 N.E. 1055 (1894) (bondholder may bring equitable action to foreclose mortgage without

first seeking appointment of new trustee after original trustee became incompetent). It seems clear therefore that plaintiffs' cause of action for fraud accrued no later than March 16, 1979 when the purchase price for NEI stock was adjusted, and the dismissal of all claims not filed within six years of this event was proper.

B. *Plaintiffs' Contractual Claims Against National*

All of plaintiffs' claims -- including contract claims -- were held to be time-barred. Based on plaintiffs' allegations, the district court believed each of plaintiffs' theories as to liability rested on **[**40]** allegations of fraud in the formation of corporations that are separate **[*975]** entities in name only. 1990Fed. Sec. L. Rep. para. 95,466 at 97,417. This assumption led it to apply the accrual date for fraudulent transfers to plaintiffs' contract claims, and to dismiss them as untimely as well. Because the assumption was flawed, the wrong conclusion followed.

Count III of the Sibalin amended complaint (and the other amended complaints contain similar allegations) states that this claim is one "arising under the indenture" and defendant "breached the indentures". This language clearly signalled a contract cause of action, which the district court mistakenly viewed as an allegation "of fraud in the formation of corporations which are separate entities by name alone." Since we believe Count III states a contract claim for breach of the Indenture, it must be analyzed as such.

1. The Statute of Limitations

As just discussed in reference to the applicable statute of limitations for suits against the Trustees, there is a six-year statute of limitations applicable to suits based on alleged breach of the Indentures. *See* N.Y. Civ. Prac. L. & R. § 213(2) (McKinney 1991). On the subject **[**41]** of accrual, each of the Indentures contains a so-called "no action" clause that proscribes suit by debenture holders against the issuer unless the Trustee is given written notice of default (as defined in the Indenture), 25 percent in aggregate principal amount holders serve a written request for suit upon the Trustee, the holders offer to indemnify the Trustee for litigation expenses, and the Trustee takes no action for 30 (or 60) days. Alternatively -- and regardless of compliance with these terms -- debenture holders may sue the *issuer* for breach of the Indentures once there has been a default in payment of principal or interest.

Thus, just as with plaintiffs' claims against the Trustees for breaches of the Indentures, the statute of limitations for actions against the issuer because of failure to pay principal or interest did not begin to run until August 1983 when Computer and International defaulted. Under New York law, the six-year limitations period for these actions brought on the Indentures did not expire until August 1989. The actions brought in 1985 by the Cruden plaintiffs and in 1987 by Sibalin are therefore timely insofar as they allege National breached the Indentures **[**42]** by failing to pay principal or interest when due, and it was error to dismiss them as time-barred.

2. Liability for Breach of the Indenture

National moved for summary judgment dismissing these claims as time-barred. All plaintiffs cross-moved for summary judgment on the issue of liability for breach of the Indentures, though Sibalin's motion was later withdrawn. The district court disposed of these motions for summary judgment ruling for National in all instances. Therefore, although the parties do not raise the issue on appeal, the issue of liability for breach of the Indentures is properly before us with respect to the Cruden plaintiffs. *See International Longshoremen's Ass'n, AFL-CIO v. Seatrain Lines, Inc.,* 326 F.2d 916, 920-21 (2d Cir. 1964); *First Nat. Bank in Yonkers v. Maryland Cas. Co.,* 290 F.2d 246, 251 (2d Cir), *cert. denied,* 368 U.S. 939, 7 L. Ed. 2d 338, 82 S. Ct. 381 (1961); *see also United States Trust Co. of New York v. Executive Life Ins. Co.,* 602 F. Supp. 930, 936 (S.D.N.Y. 1984), *aff'd,* 791 F.2d 10 (2d Cir. 1986) (interpretation of indentures "ordinarily well-suited for a motion for summary judgment"). **[**43]**

In deciding whether to grant summary judgment all inferences drawn from the materials submitted to the trial court are viewed in a light most favorable to the party opposing the motion. The nonmovant's allegations are taken as true and it receives the benefit of the doubt when its assertions conflict with those of the movant. *See Taggart v. Time Inc.,* 924 F.2d 43, 46 (2d Cir. 1991); *Burtnieks v. City of New York,* 716 F.2d 982, 985-86 (2d Cir. 1983). Only when no reasonable trier of fact could find in favor of the nonmoving party should summary judgment be granted. *H.L. Hayden Co. of New York, Inc. v. Siemens Medical Sys., Inc.,* 879 F.2d 1005, 1011 (2d Cir. 1989).

**[*976]** Under New York law, a written contract is

to be interpreted so as to give effect to the intention of the parties as expressed in the unequivocal language they have employed. *See Breed v. Insurance Co. of North America,* 46 NY2d 351, 355, 413 N.Y.S.2d 352, 385 N.E.2d 1280 (1978). Construing an unambiguous contract provision is a function of the court, rather than a jury, and matters extrinsic to the agreement may not be considered when the intent of the parties can fairly be gleaned **[**44]** from the face of the instrument. *See Teitelbaum Holdings, Ltd. v. Gold,* 48 NY2d 51, 56, 421 N.Y.S.2d 556, 396 N.E.2d 1029 (1979). A court may neither rewrite, under the guise of interpretation, a term of the contract when the term is clear and unambiguous, *Fiore v. Fiore,* 46 NY2d 971, 973, 415 N.Y.S.2d 826, 389 N.E.2d 138 (1979), nor redraft a contract to accord with its instinct for the dispensation of equity upon the facts of a given case. *See DeVanzo v. Newark Ins. Co.,* 44 AD2d 39, 43, 353 N.Y.S.2d 29 (2d Dep't 1974), *aff'd,* 37 N.Y.2d 733, 374 N.Y.S.2d 619, 337 N.E.2d 131 (1975). Further, the entire contract must be considered, and all parts of it reconciled, if possible, in order to avoid an inconsistency. *See Laba v. Carey,* 29 NY2d 302, 308, 327 N.Y.S.2d 613, 277 N.E.2d 641 (1971); *National Conversion Corp. v. Cedar Bldg. Corp.,* 23 N.Y.2d 621, 625, 298 N.Y.S.2d 499, 246 N.E.2d 351 (1969). With these principles in mind we turn to the facts of this case.

In 1972 Levin-Townsend formed two corporations: Computer and National. Upon consummation of the reorganization on August 8, 1973 Computer became a wholly-owned subsidiary of National. Former Levin-Townsend shareholders received shares of National common stock in exchange for their shares in Levin-Townsend. **[**45]** Under the terms of the Supplemental Indentures entered into shortly thereafter, Computer assumed Levin-Townsend's payment obligations under the Bank of New York, Sterling, and Irving debentures, and Levin-Townsend's guarantee obligations under the Bankers Trust debentures, but National explicitly assumed only the conversion obligations, that is, the former Levin-Townsend and International debentures became convertible only into National's stock.

Under Article 1, § 1.01 of the Indentures, the term "Company" is defined as "Levin-Townsend Computer Corporation, and, subject to the provisions of Article Fourteen, . . . its successors and assigns." The Indentures only allowed the "Company" to assume conversion liability of Levin-Townsend. The Sterling Indenture, typical of all, provides:

> Subject to and upon compliance with the provisions of Section 2.05, and this Article Four, at the option of the holder thereof, *any Debenture . . . may,* at any time before the close of business on August 1, 1983, . . . *be converted* at the principal amount thereof . . . into fully-paid and non-assessable shares (calculated as to each conversion to the nearest 1/100th of a share) of Common Stock, **[**46]** at the conversion price, determined as hereinafter provided, in effect at the time of conversion.

Sterling Indenture at § 4.01 (emphasis added). The "Common Stock" is precisely defined in the Indentures. It is the common stock of the "Company":

> *The term "Common Stock",* when used with reference to stock of the Company, *shall mean* (i) *the class of stock which,* at the date of execution of this Indenture as originally executed, *is designated as common stock of the Company* and stock of any other class or classes into which such common stock or any such other class may thereafter be changed or reclassified . . . *provided, however, that,* subject to the provisions of § 4.05, *shares issuable on conversion of Debentures shall include only "Common Stock" of the Company* as defined in clause (i) above.

Sterling Indenture at § 1.01 (emphasis added). Thus, the debentures issued by Levin-Townsend and International could only be converted into the common stock of the "Company," and the "Company" is defined to include Levin-Townsend and its successors. National -- by virtue of its having assumed the conversion obligations -- became **[*977]** a successor to Levin-Townsend. *Cf. Broad v. Rockwell Int'l Corp.,* 642 F.2d 929, 946-56 **[**47]** (5th Cir.), *cert. denied,* 454 U.S. 965, 102 S. Ct. 506, 70 L. Ed. 2d 380 (1981) (court must interpret unambiguous indenture provisions governing conversion rights).

Pursuant to § 17.02 of the Sterling Indenture -- and similar provisions of the Bank of New York, Irving, and Bankers Trust Indentures -- all covenants, stipulations, promises, and agreements in the Indentures are binding on successors and assigns of Levin-Townsend, whether so expressed or not. Therefore, National, as Levin-Townsend's successor, is liable for Levin-Townsend's payment obligations under the Bank of New York, Irving, and Sterling Indentures. And National is liable for breach of the payment obligations

under these Indentures that occurred beginning in August 1983. The same reasoning compels the conclusion that National is liable as a successor of Levin-Townsend for Levin-Townsend's guarantee of the Bankers Trust bond issue.

As the Cruden plaintiffs sought in their cross-motion only a judgment as to liability, we must remand the case to the district court for a trial on damages. Because Sibalin withdrew its motion for summary judgment on the issue of National's successor liability due to its assumption of Levin-Townsend's **[**48]** conversion obligation under the Bankers Trust issue, this portion of the case must also be remanded in order to allow Sibalin an opportunity to renew its motion and then proceed to trial on the issue of damages.

C. *Plaintiffs' Claims for Piercing the Corporate Veil*

Because we have already found that National is the successor (within the meaning of the Indentures) to Levin-Townsend by virtue of its having assumed Levin-Townsend's conversion obligations, a consideration of plaintiffs' alternative claims for piercing the corporate veil and successor liability under general corporate law principles is unnecessary.

D. *Plaintiffs' RICO Claims Against Townsend and National*

Counts VII & VIII of plaintiffs' complaints allege RICO violations against Townsend and National. The district court dismissed these claims as time barred, finding they rested on the same fraudulent transfers which underlie the fraud causes of action asserted in Counts V and VI.

In *Bankers Trust,* we held that as an element of proof in civil RICO claims brought under 18 U.S.C. § 1964(c), a plaintiff must show he has been "injured in his business or property" by reason of a violation of 18 U.S.C. § 1962. 859 F.2d at 1102. **[**49]** "Until such injury occurs, there is no right to sue for damages under § 1964(c), and until there is a right to sue under § 1964(c), a civil RICO action cannot be held to have accrued." *Id.* (citing *Sedima v. Imrex Co.,* 473 U.S. 479, 496, 87 L. Ed. 2d 346, 105 S. Ct. 3275 (1985)).

The type of injury required under § 1964(c) cannot he said to have occurred where the damages arising from defendant's conduct are speculative or their amount and nature unprovable." *Zenith Radio Corp. v. Hazeltine Research, Inc.,* 401 U.S. 321, 339, 28 L. Ed. 2d 77, 91 S. Ct. 795 (1971). In such cases, a refusal to award future damages as speculative is simply another way of ruling the only cause of action that has accrued is one for those damages already suffered. Causes of action for future damages become viable, *i.e.,* accrue, when the damages actually occur.

*Bankers Trust,* recognizing that RICO violations may result in multiple injuries over time, adopted a rule of separate accrual. 859 F.2d at 1104-05. Consequently, "each time plaintiff discovers or should have discovered an injury caused by defendant's violation of § 1962, a new cause of action arises as to that injury, regardless of when the actual **[**50]** violation occurred." *Id.* at 1105. Once the cause of action accrues, a uniform four-year statute of limitations begins to run anew regardless of when the first overt act causing damage may have occurred. *Id.* at 1104-05.

Plaintiffs were injured within the meaning of § 1964(c) when Computer and **[*978]** International defaulted in 1983. Hence, regardless of when other RICO *violations* may have occurred, plaintiffs' RICO *cause of action* accrued at the time of default, and the four-year statute of limitations began to run on the action at that time. Defendants argue that plaintiffs' injury occurred at the time of the alleged fraudulent transfers. We are unpersuaded by this argument. Prior to Computer's and International's defaults in 1983, the particular injury was speculative and consequently not remediable under § 1964(c). *See id.* at 1103; *see also Zenith Radio Corp.,* 401 U.S. at 339. Unlike defendants' fraudulent actions which gave rise to claims for relief under theories of common law fraud or New York's Debtor-Creditor Law when engaged in or discovered, *see supra,* at 29-30, defendants' RICO violations **[**51]** did not give rise to a claim for relief under § 1964(c) until those violations resulted in an injury to plaintiffs' business or property -- when Computer and International defaulted on their principal and/or interest payments. All plaintiffs filed their complaints within four years of these defaults. Consequently, the district court erred in dismissing plaintiffs' RICO claims against Townsend and National as untimely.

CONCLUSION

The judgment dismissing the Cruden plaintiffs' pre-bankruptcy claims against the Trustees is affirmed as

to defendants Sterling, Bank of New York, and Irving based on proper reliance on opinions of counsel. The judgment dismissing Sibalin's pre-bankruptcy claims against Bankers Trust as time-barred is reversed and the case is remanded for further proceedings consistent with this opinion.

National, as the contractual successor to Levin-Townsend, is liable for breaches of the Indentures' payment obligations that occurred beginning in 1983. On remand the district court should hold a trial, if necessary, on the issue of damages to the Cruden plaintiffs arising from those breaches. Sibalin's motion for summary judgment is to be reinstated with respect to National's **[**52]** liability as Levin-Townsend's successor and this aspect of the case should then proceed to trial, if necessary, on the issue of damages. Because of our holding that National is liable as Levin-Townsend's contractual successor for failure to pay principal and interest, the grant of summary judgment in favor of National dismissing plaintiffs' successor liability and piercing claims is vacated as moot.

The grant of summary judgment in favor of National and Townsend dismissing plaintiffs' civil RICO claims as time-barred is also reversed, and this aspect of the case is remanded for further proceedings consistent with this opinion.

In all other respects the district court's judgments are affirmed.

# TAB 24

**Blanche B. Rainbow, Respondent, v. Gerald W. Swisher, Appellant**

**[NO NUMBER IN ORIGINAL]**

**Court of Appeals of New York**

**72 N.Y.2d 106; 527 N.E.2d 258; 531 N.Y.S.2d 775; 1988 N.Y. LEXIS 1658**

**June 1, 1988, Argued**
**July 6, 1988, Decided**

**PRIOR HISTORY:** Appeal, by permission of the Court of Appeals, from an order of the Appellate Division of the Supreme Court in the Fourth Judicial Department, entered September 30, 1987, which affirmed a judgment of the Supreme Court (Thomas J. Murphy, J.), entered in Onondaga County after a nonjury trial, awarding plaintiff the total sum of $ 19,941.54 against defendant.

*Rainbow v Swisher*, 133 AD2d 552.

**DISPOSITION:** Order affirmed, with costs.

**COUNSEL:** *David P. Martin* for appellant. I. The stipulation of settlement is unenforceable since the parties intended it to merge in the divorce decree. ( *Jensen v Jensen*, 110 AD2d 679; *Jaeckel v Jaeckel*, 179 Misc 994; *McMains v McMains*, 15 NY2d 283; *Matter of Moller*, 157 Misc 338; *Matter of Hall v Hall*, 82 Misc 2d 814, 55 AD2d 752; *Nicoletti v Nicoletti*, 43 AD2d 699; *Matter of Fishman v Fisher*, 77 AD2d 596; *Avella v Avella*, 74 AD2d 592; *Matter of Lynch v Pierce*, 60 AD2d 930; *Matter of Boden v Boden*, 42 NY2d 210.) II. Appellant may collaterally attack the divorce decree. ( *Nopper v Nopper*, 50 NY2d 1009; *Kleila v Kleila*, 50 NY2d 277; *MacDonald v MacDonald*, 73 AD2d 958; *Goldman v Goldman*, 69 AD2d 758; *Chanin v Chanin*, 59 AD2d 671.) III. The divorce decree should be corrected to provide that the stipulation merged with the decree, and thus, did not survive the decree. ( *Crain v Crain*, 109 AD2d 1094; *Fehlhaber Corp. v State of New York*, 64 Misc 2d 167, 40 AD2d 881.)

*Barry R. Hill* for respondent. I. Where an ambiguity exists between a clause in a stipulation of settlement and a provision in a judgment of divorce, the remedy is appeal and the judgment cannot be collaterally attacked. ( *Chanin v Chanin*, 59 AD2d 671; *Goldman v Goldman*, 69 AD2d 758; *MacDonald v MacDonald*, 73 AD2d 958; *Nopper v Nopper*, 72 AD2d 827, 50 NY2d 1009.) II. Whether the parties intended the stipulation of separation to merge and not survive or not merge and survive in the judgment of divorce was an issue resolved by the trial court in favor of plaintiff for nonmerger and survival. ( *Arnold v State of New York*, 108 AD2d 1021; *Strauf v Ettson Enters.*, 106 AD2d 737; *Matter of McCarthy v Braiman*, 125 AD2d 572; *Sureau v Sureau*, 305 NY 720; *Tamas v Tamas*, 47 AD2d 686.) II. The conflict of whether or not the stipulation of settlement shall survive or not survive the judgment of divorce must be construed against defendant. ( *Rentways, Inc. v O'Neill Milk & Cream Co.*, 308 NY 342.) IV. Defendant's position at the time of trial that the stipulation of settlement shall be merged in the judgment of divorce is totally inconsistent with his prior positions. V. Defendant is estopped from seeking to disregard the terms of the judgment of divorce. ( *Horn v Bennett*, 253 App Div 630; *Tamas v Tamas*, 47 AD2d 686.) VI. The ambiguity existing between the stipulation of settlement and judgment of divorce is not a mistake, defect or irregularity to warrant a correction via CPLR 5019 (a). ( *Herpe v Herpe*, 225 NY 323.)

**JUDGES:** Kaye, J. Chief Judge Wachtler and Judges

Simons, Alexander, Titone, Hancock, Jr., and Bellacosa concur.

**OPINION BY:** KAYE

**OPINION**

**[*108] [***775] [**258] OPINION OF THE COURT**

A judgment of divorce entered by a court with subject matter and personal jurisdiction is not, in the circumstances presented, open to later collateral attack on the ground that the judgment erroneously failed to embody the terms of the parties' settlement agreement regarding merger of the agreement into the decree. Given the nature of the alleged error and the parties' long reliance on the judgment, defendant husband cannot now challenge its accuracy.

**[***776]** After 23 years of marriage and six children, plaintiff began an action in Supreme Court for divorce, which was contested by defendant. Before trial actually commenced, on May 3, 1978 the parties -- both **[**259]** represented by counsel -- signed a stipulation of settlement, whereby defendant withdrew his answer and agreed to allow plaintiff to obtain a judgment of divorce. The agreement settled the rights of the parties with respect to child custody, visitation, child support, alimony, property division and other economic incidents of the marriage, including health and life insurance. The final paragraph provided that it "shall be submitted to the Justice presiding at the matrimonial action part and that such Stipulation and Agreement shall become incorporated into and shall merge into any Judgment of Divorce granted to the parties herein." Nevertheless, the judgment of divorce issued by Supreme Court some five weeks later provided, in one of its decretal paragraphs, "that the terms of the written stipulation of settlement, dated May 3, 1978, relating to custody, visitation, support and alimony, and signed by the parties shall be incorporated, but shall not merge, in this decree." Neither party made any objection to the judgment or took an appeal. Indeed, in subsequent proceedings against each other in New York and in Connecticut, both parties relied on the judgment without questioning its validity or accuracy.

In 1983, plaintiff commenced the present breach of contract action to recover arrears in child support and alimony due under the settlement agreement. Defendant's answer, dated February 1984, contained denials and affirmative defenses, but in no way disputed the judgment itself. Two years later, in response to plaintiff's amended complaint claiming additional arrears through February 1986, defendant for the first time asserted, as an affirmative defense, that the intent of the parties, as expressed in the stipulation of settlement, was to **[*109]** merge the agreement into any subsequent divorce decree, and that the agreement therefore did not survive the decree as a separately enforceable contract. Following a bench trial, Supreme Court awarded judgment against defendant, concluding that the present action could be maintained under the terms of the settlement agreement. Rejecting defendant's argument that the agreement was unenforceable by its own terms, the court held that the judgment of divorce provided otherwise, that the divorce court had jurisdiction over the parties, and that its ruling on the effect of the settlement agreement was final and binding. The Appellate Division affirmed, without opinion, and this court granted leave to appeal. We now affirm.

The settlement agreement upon which the present action is based states that it was to merge into any judgment of divorce later granted to these parties. If merged, the agreement would cease to exist as a separately enforceable contract *(see, McMains v McMains*, 15 NY2d 283, 287; *Jaeckel v Jaeckel*, 179 Misc 994, 997; 2 Foster and Freed, Law and the Family, New York § 28:53, at 462-463 [1966]). If not merged, the agreement may survive as a basis for suit, independent of other available procedures for enforcing the decree *(see, Merl v Merl*, 67 NY2d 359, 362; *Goldman v Goldman*, 282 NY 296; *see also*, 1 Tippins, New York Matrimonial Law and Practice § 8:06, at 20 [1986]).

Supreme Court apparently viewed the merger issue as one of fact. The court found, after trial, that there was "insufficient evidence" to warrant a finding that it was the parties' intent to merge the settlement agreement into any subsequent judgment of divorce. Plaintiff urges that this finding, affirmed by the Appellate Division and supported by the record, alone compels affirmance *(see, Humphrey v State of New York*, 60 NY2d 742, 743-744). We disagree. The settlement agreement is a contract subject to principles of contract interpretation *( Clayburgh v Clayburgh*, 261 NY 464, 469; *Matter of Baker v Baker*, 33 AD2d 812). Where, as here, the contract is clear and unambiguous on its face, the

**[***777]** intent of the parties must be gleaned from within the four corners of the instrument, and not from extrinsic evidence *( Nichols v Nichols*, 306 NY 490, 496; **[**260]** *see also, Chimart Assocs. v Paul*, 66 NY2d 570). There being no ambiguity in this contract with respect to the intent of the parties that the settlement agreement should merge into the divorce decree, we proceed to consider the legal question whether the judgment is subject to collateral attack **[*110]** by defendant based on the divorce court's alleged error in reciting that the agreement did not merge into the judgment.

In general, a final judgment of divorce issued by a court having both subject matter and personal jurisdiction has the effect of determining the rights of the parties with respect to every material issue that was actually litigated or might have been litigated *(see, Schuylkill Fuel Corp. v Nieberg Realty Corp*., 250 NY 304, 306-307; *Marinelli v Marinelli*, 88 AD2d 635, 636; *D'Auria v D'Auria*, 200 Misc 939, 942; 1 Foster, Freed and Brandes, Law and the Family, New York § 6:38, at 512 [2d ed 1987]). Consequently, where there is a conflict between a settlement agreement and the decretal provisions of a later divorce judgment, the judgment will govern *(see, e.g., Greschler v Greschler*, 51 NY2d 368, 376; *Lynn v Lynn*, 302 NY 193, 201-203, *cert denied* 342 U.S. 849; *Okun v Okun*, 66 Misc 2d 241, 242). Moreover, absent unusual circumstances or explicit statutory authorization, the provisions of the judgment are final and binding on the parties, and may be modified only upon direct challenge *( D'Auria v D'Auria, supra*; 47 NY Jur 2d, Domestic Relations, § 1218, at 855).

Applying these general principles, defendant's failure to seek modification of, or to appeal, the judgment of divorce bound him to its terms, including the provision for survival of the settlement agreement *( MacDonald v MacDonald*, 73 AD2d 958, 959; *Nopper v Nopper*, 72 AD2d 827, *affd on other grounds* 50 NY2d 1009). True, a divorce judgment may be subject to collateral attack in cases where a divorce court is without competence to entertain the matter *( Lacks v Lacks*, 41 NY2d 71, 74-76; *see also*, Foster and Freed, *1977 Survey of New York Law, Family Law*, 29 Syracuse L Rev 569, 574-575 [discussing *Lacks]*; Meyer, *Some Thoughts on Statutory Interpretation with Special Emphasis on Jurisdiction*, 15 Hofstra L Rev 167, 180-182 [1987]). But that exception does not apply here. The judgment was rendered by a court plainly vested with subject matter and personal jurisdiction. Its error -- if indeed error -- did not go to competence to adjudicate the dispute, but to a matter readily correctable upon timely application for modification or appeal *( Lacks v Lacks, supra; see also, Nuernberger v State of New York*, 41 NY2d 111, 115-118; *Thrasher v United States Liab. Ins. Co*., 19 NY2d 159, 166).

Finally, the circumstances of this case preclude a contrary conclusion. To rewrite a judgment of divorce which has been relied on by both parties for 10 years would defeat the **[*111]** plaintiff's reasonable expectation that the judgment was valid as entered, and would subvert the policy of upholding settled domestic relations that underlies the doctrine of equitable estoppel in divorce cases *(see generally, Krause v Krause*, 282 NY 355, 359-360; Clark, *Estoppel Against Jurisdictional Attack on Decrees of Divorce*, 70 Yale LJ 45 [1960]).

Accordingly, the order of the Appellate Division should be affirmed, with costs.

# TAB 25

2014 SCC 53, 2014 CSC 53
Supreme Court of Canada

Creston Moly Corp. v. Sattva Capital Corp.

2014 CarswellBC 2267, 2014 CarswellBC 2268, 2014 SCC 53, 2014 CSC 53, [2014] 2 S.C.R. 633, [2014] 9 W.W.R. 427, [2014] B.C.W.L.D. 5218, [2014] B.C.W.L.D. 5219, [2014] B.C.W.L.D. 5230, [2014] B.C.W.L.D. 5255, [2014] S.C.J. No. 53, 242 A.C.W.S. (3d) 266, 25 B.L.R. (5th) 1, 358 B.C.A.C. 1, 373 D.L.R. (4th) 393, 461 N.R. 335, 59 B.C.L.R. (5th) 1, 614 W.A.C. 1

# Sattva Capital Corporation (formerly Sattva Capital Inc.), Appellant and Creston Moly Corporation (formerly Georgia Ventures Inc.), Respondent and Attorney General of British Columbia and BCICAC Foundation, Interveners

McLachlin C.J.C., LeBel, Abella, Rothstein, Moldaver, Karakatsanis, Wagner JJ.

Heard: December 12, 2013
Judgment: August 1, 2014
Docket: 35026

Proceedings: reversing *Creston Moly Corp. v. Sattva Capital Corp.* (2012), 554 W.A.C. 114, 326 B.C.A.C. 114, 2 B.L.R. (5th) 1, 36 B.C.L.R. (5th) 71, 2012 BCCA 329, 2012 CarswellBC 2327, Bennett J.A., Kirkpatrick J.A., Neilson J.A. (B.C. C.A.); reversing *Creston Moly Corp. v. Sattva Capital Corp.* (2011), 2011 CarswellBC 1124, 2011 BCSC 597, 84 B.L.R. (4th) 102, Armstrong J. (B.C. S.C.); and reversing *Creston Moly Corp. v. Sattva Capital Corp.* (2010), 319 D.L.R. (4th) 219, 2010 BCCA 239, 2010 CarswellBC 1210, 7 B.C.L.R. (5th) 227, Levine J.A., Low J.A., Newbury J.A. (B.C. C.A.); reversing *Creston Moly Corp. v. Sattva Capital Corp.* (2009), 2009 BCSC 1079, 2009 CarswellBC 2096, Greyell J. (B.C. S.C.)

Counsel: Michael A. Feder, Tammy Shoranick, for Appellant
Darrell W. Roberts, Q.C., David Mitchell, for Respondent
Jonathan Eades, Micah Weintraub, for Intervener, Attorney General of British Columbia
David Wotherspoon, Gavin R. Cameron, for Intervener, BCICAC Foundation

Subject: Civil Practice and Procedure; Contracts; Corporate and Commercial; Public

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**Words and phrases considered:**

**Contractual interpretation**

Contractual interpretation involves issues of mixed fact and law as it is an exercise in which the principles of contractual interpretation are applied to the words of the written contract, considered in light of the factual matrix.

**fee paid in shares**

There is an inherent risk in accepting a fee paid in shares that is not present when accepting a fee paid in cash. A fee paid in cash has a specific predetermined value. By contrast, when a fee is paid in shares, the price of the shares (or mechanism to determine the price of the shares) is set in advance. However, the price of those shares on the market will change over time. The recipient of a fee paid in shares hopes the share price will rise resulting in shares with a market value greater than the value of the shares at the predetermined price. However, if the share price falls, the recipient will receive shares worth less than the value of the shares at the predetermined price. This risk is well known to those operating in the business sphere and both [the respondent and the appellant] would have been aware of this as sophisticated business parties.

**surrounding circumstances**

While the surrounding circumstances will be considered in interpreting the terms of a contract, they must never be allowed to overwhelm the words of that agreement . . . . The goal of examining such evidence is to deepen a decision-maker's understanding of the mutual and objective intentions of the parties as expressed in the words of the contract. The interpretation of a written contractual provision must always be grounded in the text and read in light of the entire contract . . . . While the surrounding circumstances are relied upon in the interpretive process, courts cannot use them to deviate from the text such that the court effectively creates a new agreement.

The nature of the evidence that can be relied upon under the rubric of "surrounding circumstances" will necessarily vary from case to case. It does, however, have its limits. It should consist only of objective evidence of the background facts at the time of the execution of the contract . . . , that is, knowledge that was or reasonably ought to have been within the knowledge of both parties at or before the date of contracting. Subject to these requirements and the parol evidence rule discussed below, this includes, in the words of Lord Hoffmann, "absolutely anything which would have affected the way in which the language of the document would have been understood by a reasonable man" . . . . Whether something was or reasonably ought to have been within the common knowledge of the parties at the time of execution of the contract is a question of fact.

**Termes et locutions cités:**

**circonstances**

Bien que les circonstances soient prises en considération dans l'interprétation des termes d'un contrat, elles ne doivent jamais les supplanter (...). Le décideur examine cette preuve dans le but de mieux saisir les intentions réciproques et objectives des parties exprimées dans les mots du contrat. Une disposition contractuelle doit toujours être interprétée sur le fondement de son libellé et de l'ensemble du contrat (...). Les circonstances sous-tendent l'interprétation du contrat, mais le tribunal ne saurait fonder sur elles une lecture du texte qui s'écarte de ce dernier au point de créer dans les faits une

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nouvelle entente (...).

La nature de la preuve susceptible d'appartenir aux « circonstances » variera nécessairement d'une affaire à l'autre. Il y a toutefois certaines limites. Il doit s'agir d'une preuve objective du contexte factuel au moment de la signature du contrat (...), c'est-à-dire, les renseignements qui appartenaient ou auraient raisonnablement dû appartenir aux connaissances des deux parties à la date de signature ou avant celle-ci. Compte tenu de ces exigences et de la règle d'exclusion de la preuve extrinsèque que nous verrons, on entend par « circonstances, pour reprendre les propos du lord Hoffmann [TRADUCTION] « tout ce qui aurait eu une incidence sur la manière dont une personne raisonnable aurait compris les termes du document » (...). La question de savoir si quelque chose appartenait ou aurait dû raisonnablement appartenir aux connaissances communes des parties au moment de la signature du contrat est une question de fait.

**honoraires sous forme d'actions**

Le versement des honoraires sous forme d'actions présente un risque inhérent, qui ne se pose pas dans le cas du versement en argent. Les honoraires payés en argent ont une valeur prédéterminée. Par contre, quand les honoraires sont versés en actions, le cours de l'action (ou le mécanisme permettant de le déterminer) est fixé à l'avance. Cependant, le cours de l'action fluctue avec le temps. La personne qui reçoit des honoraires payés en actions espère une augmentation du cours, de sorte que ses actions auront une valeur marchande supérieure à celle qui est établie selon le cours prédéterminé. En revanche, si le cours chute, cette personne reçoit des actions dont la valeur est inférieure à celle des actions selon le cours prédéterminé. Ce risque est bien connu de ceux qui évoluent dans ce milieu, et [l'intimée et l'appelante], des parties avisées, en auraient eu connaissance.

**interprétation contractuelle**

L'interprétation contractuelle soulève des questions mixtes de fait et de droit, car il s'agit d'en appliquer les principes aux termes figurant dans le contrat écrit, à la lumière du fondement factuel.

APPEAL from judgment reported at *Creston Moly Corp. v. Sattva Capital Corp.* (2012), 2012 BCCA 329, 2012 CarswellBC 2327, 36 B.C.L.R. (5th) 71, 2 B.L.R. (5th) 1, 326 B.C.A.C. 114, 554 W.A.C. 114 (B.C. C.A.), reversing dismissal of appeal from arbitrator's decision; APPEAL from judgment reported at *Creston Moly Corp. v. Sattva Capital Corp.* (2010), 2010 BCCA 239, 2010 CarswellBC 1210, 319 D.L.R. (4th) 219, 7 B.C.L.R. (5th) 227 (B.C. C.A.), reversing decision to dismiss application for leave to appeal arbitrator's award of damages.

POURVOI formé à l'encontre d'un jugement publié à *Creston Moly Corp. v. Sattva Capital Corp.* (2012), 2012 BCCA 329, 2012 CarswellBC 2327, 36 B.C.L.R. (5th) 71, 2 B.L.R. (5th) 1, 326 B.C.A.C. 114, 554 W.A.C. 114 (B.C. C.A.), ayant infirmé le rejet d'un appel interjeté à l'encontre d'une sentence arbitrale; POURVOI formé à l'encontre d'un jugement publié à *Creston Moly Corp. v. Sattva Capital Corp.* (2010), 2010 BCCA 239, 2010 CarswellBC 1210, 319 D.L.R. (4th) 219, 7 B.C.L.R. (5th) 227 (B.C. C.A.), ayant infirmé la décision de rejeter la demande d'autorisation d'appeler à l'encontre de la sentence arbitrale portant sur les dommages-intérêts.

***Rothstein J.* (McLachlin C.J.C. and LeBel, Abella, Moldaver, Karakatsanis and Wagner JJ. concurring):**

1 When is contractual interpretation to be treated as a question of mixed fact and law and when should it be treated as a question of law? How is the balance between reviewability and finality of commercial arbitration awards under the *Commercial Arbitration Act*, R.S.B.C. 1996, c. 55 (now the *Arbitration Act*, hereinafter the "*AA*"), to be determined? Can findings made by a court granting leave to appeal with respect to the merits of an appeal bind the court that ultimately decides the appeal? These are three of the issues that arise in this appeal.

## I. Facts

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2 The issues in this case arise out of the obligation of Creston Moly Corporation (formerly Georgia Ventures Inc.) to pay a finder's fee to Sattva Capital Corporation (formerly Sattva Capital Inc.). The parties agree that Sattva is entitled to a finder's fee of US$1.5 million and is entitled to be paid this fee in shares of Creston, cash or a combination thereof. They disagree on which date should be used to price the Creston shares and therefore the number of shares to which Sattva is entitled.

3 Mr. Hai Van Le, a principal of Sattva, introduced Creston to the opportunity to acquire a molybdenum mining property in Mexico. On January 12, 2007, the parties entered into an agreement (the "Agreement") that required Creston to pay Sattva a finder's fee in relation to the acquisition of this property. The relevant provisions of the Agreement are set out in Appendix I.

4 On January 30, 2007, Creston entered into an agreement to purchase the property for US$30 million. On January 31, 2007, at the request of Creston, trading of Creston's shares on the TSX Venture Exchange ("TSXV") was halted to prevent speculation while Creston completed due diligence in relation to the purchase. On March 26, 2007, Creston announced it intended to complete the purchase and trading resumed the following day.

5 The Agreement provides that Sattva was to be paid a finder's fee equal to the maximum amount that could be paid pursuant to s. 3.3 of Policy 5.1 in the TSXV Policy Manual. Section 3.3 of Policy 5.1 is incorporated by reference into the Agreement at s. 3.1 and is set out in Appendix II of these reasons. The maximum amount pursuant to s. 3.3 of Policy 5.1 in this case is US$1.5 million.

6 According to the Agreement, by default, the fee would be paid in Creston shares. The fee would only be paid in cash or a combination of shares and cash if Sattva made such an election. Sattva made no such election and was therefore entitled to be paid the fee in shares. The finder's fee was to be paid no later than five working days after the closing of the transaction purchasing the molybdenum mining property.

7 The dispute between the parties concerns which date should be used to determine the price of Creston shares and thus the number of shares to which Sattva is entitled. Sattva argues that the share price is dictated by the Market Price definition at s. 2 of the Agreement, i.e. the price of the shares "as calculated on close of business day before the issuance of the press release announcing the Acquisition". The press release announcing the acquisition was released on March 26, 2007. Prior to the halt in trading on January 31, 2007, the last closing price of Creston shares was $0.15. On this interpretation, Sattva would receive approximately 11,460,000 shares (based on the finder's fee of US$1.5 million).

8 Creston claims that the Agreement's "maximum amount" proviso means that Sattva cannot receive cash or shares valued at more than US$1.5 million on the date the fee is payable. The shares were payable no later than five days after May 17, 2007, the closing date of the transaction. At that time, the shares were priced at $0.70 per share. This valuation is based on the price an investment banking firm valued Creston at as part of underwriting a private placement of shares on April 17, 2007. On this interpretation, Sattva would receive approximately 2,454,000 shares, some 9 million fewer shares than if the shares were priced at $0.15 per share.

9 The parties entered into arbitration pursuant to the *AA*. The arbitrator found in favour of Sattva. Creston sought leave to appeal the arbitrator's decision pursuant to s. 31(2) of the *AA*. Leave was denied by the British Columbia Supreme Court (2009

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BCSC 1079 (B.C. S.C.) (CanLII) ("SC Leave Court")). Creston successfully appealed this decision and was granted leave to appeal the arbitrator's decision by the British Columbia Court of Appeal (2010 BCCA 239, 7 B.C.L.R. (5th) 227 (B.C. C.A.) ("CA Leave Court")).

10 The British Columbia Supreme Court judge who heard the merits of the appeal (2011 BCSC 597, 84 B.L.R. (4th) 102 (B.C. S.C.) ("SC Appeal Court")) upheld the arbitrator's award. Creston appealed that decision to the British Columbia Court of Appeal (2012 BCCA 329, 36 B.C.L.R. (5th) 71 (B.C. C.A.) ("CA Appeal Court")). That court overturned the SC Appeal Court and found in favour of Creston. Sattva appeals the decisions of the CA Leave Court and CA Appeal Court to this Court.

**II. Arbitral Award**

11 The arbitrator, Leon Getz, Q.C., found in favour of Sattva, holding that it was entitled to receive its US$1.5 million finder's fee in shares priced at $0.15 per share.

12 The arbitrator based his decision on the Market Price definition in the Agreement:

> What, then, was the "Market Price" within the meaning of the Agreement? The relevant press release is that issued on March 26 .... Although there was no closing price on March 25 (the shares being on that date halted), the "last closing price" within the meaning of the definition was the $0.15 at which the [Creston] shares closed on January 30, the day before trading was halted "pending news" .... This conclusion requires no stretching of the words of the contractual definition; on the contrary, it falls literally within those words. [para. 22]

13 Both the Agreement and the finder's fee had to be approved by the TSXV. Creston was responsible for securing this approval. The arbitrator found that it was either an implied or an express term of the Agreement that Creston would use its best efforts to secure the TSXV's approval and that Creston did not apply its best efforts to this end.

14 As previously noted, by default, the finder's fee would be paid in shares unless Sattva made an election otherwise. The arbitrator found that Sattva never made such an election. Despite this, Creston represented to the TSXV that the finder's fee was to be paid in cash. The TSXV conditionally approved a finder's fee of US$1.5 million to be paid in cash. Sattva first learned that the fee had been approved as a cash payment in early June 2007. When Sattva raised this matter with Creston, Creston responded by saying that Sattva had the choice of taking the finder's fee in cash or in shares priced at $0.70.

15 Sattva maintained that it was entitled to have the finder's fee paid in shares priced at $0.15. Creston asked its lawyer to contact the TSXV to clarify the minimum share price it would approve for payment of the finder's fee. The TSXV confirmed on June 7, 2007 over the phone and August 9, 2007 via email that the minimum share price that could be used to pay the finder's fee was $0.70 per share. The arbitrator found that Creston "consistently misrepresented or at the very least failed to disclose fully the nature of the obligation it had undertaken to Sattva" (para. 56(k)) and "that in the absence of an election otherwise, Sattva is entitled under that Agreement to have that fee paid in shares at $0.15" (para. 56(g)). The arbitrator found that the first time Sattva's position was squarely put before the TSXV was in a letter from Sattva's solicitor on October 9, 2007.

16 The arbitrator found that had Creston used its best efforts, the TSXV could have approved the payment of the finder's fee

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in shares priced at $0.15 and such a decision would have been consistent with its policies. He determined that there was “a substantial probability that [TSXV] approval would have been given” (para. 81). He assessed that probability at 85 percent.

17 The arbitrator found that Sattva could have sold its Creston shares after a four-month holding period at between $0.40 and $0.44 per share, netting proceeds of between $4,583,914 and $5,156,934. The arbitrator took the average of those two amounts, which came to $4,870,424, and then assessed damages at 85 percent of that number, which came to $4,139,860, and rounded it to $4,140,000 plus costs.

18 After this award was made, Creston made a cash payment of US$1.5 million (or the equivalent in Canadian dollars) to Sattva. The balance of the damages awarded by the arbitrator was placed in the trust account of Sattva’s solicitors.

**III. Judicial History**

***A. British Columbia Supreme Court — Leave to Appeal Decision, 2009 BCSC 1079 (B.C. S.C.)***

19 The SC Leave Court denied leave to appeal because it found the question on appeal was not a question of law as required under s. 31 of the *AA*. In the judge’s view, the issue was one of mixed fact and law because the arbitrator relied on the “factual matrix” in coming to his conclusion. Specifically, determining how the finder’s fee was to be paid involved examining “the TSX’s policies concerning the maximum amount of the finder’s fee payable, as well as the discretionary powers granted to the Exchange in determining that amount” (para. 35).

20 The judge found that even had he found a question of law was at issue he would have exercised his discretion against granting leave because of Creston’s conduct in misrepresenting the status of the finder’s fee to the TSXV and Sattva, and “on the principle that one of the objectives of the [*AA*] is to foster and preserve the integrity of the arbitration system” (para. 41).

***B. British Columbia Court of Appeal — Leave to Appeal Decision, 2010 BCCA 239 (B.C. C.A.)***

21 The CA Leave Court reversed the SC Leave Court and granted Creston’s application for leave to appeal the arbitral award. It found the SC Leave Court “err[ed] in failing to find that the arbitrator’s failure to address the meaning of s. 3.1 of the Agreement (and in particular the ‘maximum amount’ provision) raised a question of law” (para. 23). The CA Leave Court decided that the construction of s. 3.1 of the Agreement, and in particular the “maximum amount” proviso, was a question of law because it did not involve reference to the facts of what the TSXV was told or what it decided.

22 The CA Leave Court acknowledged that Creston was “less than forthcoming in its dealings with Mr. Le and the [TSXV]” but said that “these facts are not directly relevant to the question of law it advances on the appeal” (para. 27). With respect to the SC leave judge’s reference to the preservation of the integrity of the arbitration system, the CA Leave Court said that the parties would have known when they chose to enter arbitration under the *AA* that an appeal on a question of law was possible. Additionally, while the finality of arbitration is an important factor in exercising discretion, when “a question of law arises on a matter of importance and a miscarriage of justice might be perpetrated if an appeal were not available, the integrity of the process requires, at least in the circumstances of this case, that the right of appeal granted by the legislation also be respected” (para. 29).

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***C. British Columbia Supreme Court — Appeal Decision, 2011 BCSC 597 (B.C. S.C.)***

23 Armstrong J. reviewed the arbitrator's decision on a correctness standard. He dismissed the appeal, holding the arbitrator's interpretation of the Agreement was correct.

24 Armstrong J. found that the plain and ordinary meaning of the Agreement required that the US$1.5 million fee be paid in shares priced at $0.15. He did not find the meaning to be absurd simply because the price of the shares at the date the fee became payable had increased in relation to the price determined according to the Market Price definition. He was of the view that changes in the price of shares over time are inevitable, and that the parties, as sophisticated business persons, would have reasonably understood a fluctuation in share price to be a reality when providing for a fee payable in shares. According to Armstrong J., it is indeed because of market fluctuations that it is necessary to choose a specific date to price the shares in advance of payment. He found that this was done by defining "Market Price" in the Agreement, and that the fee remained US$1.5 million in $0.15 shares as determined by the Market Price definition regardless of the price of the shares at the date that the fee was payable.

25 According to Armstrong J., that the price of the shares may be more than the Market Price definition price when they became payable was foreseeable as a "natural consequence of the fee agreement" (para. 62). He was of the view that the risk was borne by Sattva, since the price of the shares could increase, but it could also decrease such that Sattva would have received shares valued at less than the agreed upon fee of US$1.5 million.

26 Armstrong J. held that the arbitrator's interpretation which gave effect to both the Market Price definition and the "maximum amount" proviso should be preferred to Creston's interpretation of the agreement which ignored the Market Price definition.

27 In response to Creston's argument that the arbitrator did not consider s. 3.1 of the Agreement which contains the "maximum amount" proviso, Armstrong J. noted that the arbitrator explicitly addressed the "maximum amount" proviso at para. 23 of his decision.

***D. British Columbia Court of Appeal — Appeal Decision, 2012 BCCA 329 (B.C. C.A.)***

28 The CA Appeal Court allowed Creston's appeal, ordering that the payment of US$1.5 million that had been made by Creston to Sattva on account of the arbitrator's award constituted payment in full of the finder's fee. The court reviewed the arbitrator's decision on a standard of correctness.

29 The CA Appeal Court found that both it and the SC Appeal Court were bound by the findings made by the CA Leave Court. There were two findings that were binding: (1) it would be anomalous if the Agreement allowed Sattva to receive US$1.5 million if it received its fee in cash, but shares valued at approximately $8 million if Sattva took its fee in shares; and (2) the arbitrator ignored this anomaly and did not address s. 3.1 of the Agreement.

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30 The Court of Appeal found that it was an absurd result to find that Sattva is entitled to an $8 million finder's fee in light of the fact that the "maximum amount" proviso in the Agreement limits the finder's fee to US$1.5 million. The court was of the view that the proviso limiting the fee to US$1.5 million "when paid" should be given paramount effect (para. 47). In its opinion, giving effect to the Market Price definition could not have been the intention of the parties, nor could it have been in accordance with good business sense.

**IV. Issues**

31 The following issues arise in this appeal:

(a) Is the issue of whether the CA Leave Court erred in granting leave under s. 31(2) of the *AA* properly before this Court?

(b) Did the CA Leave Court err in granting leave under s. 31(2) of the *AA*?

(c) If leave was properly granted, what is the appropriate standard of review to be applied to commercial arbitral decisions made under the *AA*?

(d) Did the arbitrator reasonably construe the Agreement as a whole?

(e) Did the CA Appeal Court err in holding that it was bound by comments regarding the merits of the appeal made by the CA Leave Court?

**V. Analysis**

***A. The Leave Issue Is Properly Before This Court***

32 Sattva argues, in part, that the CA Leave Court erred in granting leave to appeal from the arbitrator's decision. In Sattva's view, the CA Leave Court did not identify a question of law, a requirement to obtain leave pursuant to s. 31(2) of the *AA*. Creston argues that this issue is not properly before this Court. Creston makes two arguments in support of this point.

33 First, Creston argues that this issue was not advanced in Sattva's application for leave to appeal to this Court. This argument must fail. Unless this Court places restrictions in the order granting leave, the order granting leave is "at large". Accordingly, appellants may raise issues on appeal that were not set out in the leave application. However, the Court may exercise its discretion to refuse to deal with issues that were not addressed in the courts below, if there is prejudice to the respondent, or if for any other reason the Court considers it appropriate not to deal with a question.

34 Here, this Court's order granting leave to appeal from both the CA Leave Court decision and the CA Appeal Court decision contained no restrictions (2013 CanLII 11315). The issue — whether the proposed appeal was on a question of law — was expressly argued before, and was dealt with in the judgments of, the SC Leave Court and the CA Leave Court. There is no reason Sattva should be precluded from raising this issue on appeal despite the fact it was not mentioned in its application for leave to appeal to this Court.

35 Second, Creston argues that the issue of whether the CA Leave Court identified a question of law is not properly before

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this Court because Sattva did not contest this decision before all of the lower courts. Specifically, Creston states that Sattva did not argue that the question on appeal was one of mixed fact and law before the SC Appeal Court and that it conceded the issue on appeal was a question of law before the CA Appeal Court. This argument must also fail. At the SC Appeal Court, it was not open to Sattva to reargue the question of whether leave should have been granted. The SC Appeal Court was bound by the CA Leave Court's finding that leave should have been granted, including the determination that a question of law had been identified. Accordingly, Sattva could hardly be expected to reargue before the SC Appeal Court a question that had been determined by the CA Leave Court. There is nothing in the *AA* to indicate that Sattva could have appealed the leave decision made by a panel of the Court of Appeal to another panel of the same court. The fact that Sattva did not reargue the issue before the SC Appeal Court or CA Appeal Court does not prevent it from raising the issue before this Court, particularly since Sattva was also granted leave to appeal the CA Leave Court decision by this Court.

36 While this Court may decline to grant leave where an issue sought to be argued before it was not argued in the courts appealed from, that is not this case. Here, whether leave from the arbitrator's decision had been sought by Creston on a question of law or a question of mixed fact and law had been argued in the lower leave courts.

37 Accordingly, the issue of whether the CA Leave Court erred in finding a question of law for the purposes of granting leave to appeal is properly before this Court.

***B. The CA Leave Court Erred in Granting Leave Under Section 31(2) of the AA***

*(1) Considerations Relevant to Granting or Denying Leave to Appeal Under the AA*

38 Appeals from commercial arbitration decisions are narrowly circumscribed under the *AA*. Under s. 31(1), appeals are limited to either questions of law where the parties consent to the appeal or to questions of law where the parties do not consent but where leave to appeal is granted. Section 31(2) of the *AA*, reproduced in its entirety in Appendix III, sets out the requirements for leave:

> (2) In an application for leave under subsection (1) (b), the court may grant leave if it determines that
>
> > (a) the importance of the result of the arbitration to the parties justifies the intervention of the court and the determination of the point of law may prevent a miscarriage of justice,
> >
> > (b) the point of law is of importance to some class or body of persons of which the applicant is a member, or
> >
> > (c) the point of law is of general or public importance.

39 The B.C. courts have found that the words "may grant leave" in s. 31(2) of the *AA* give the courts judicial discretion to deny leave even where the statutory requirements have been met (*Student Assn. of the British Columbia Institute of Technology v. British Columbia Institute of Technology*, 2000 BCCA 496, 192 D.L.R. (4th) 122 (B.C. C.A.) ("*BCIT*"), at paras. 25-26). Appellate review of an arbitrator's award will only occur where the requirements of s. 31(2) are met and where the leave court does not exercise its residual discretion to nonetheless deny leave.

40 Although Creston's application to the SC Leave Court sought leave pursuant to s. 31(2)(a), (b) and (c), it appears the

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arguments before that court and throughout focused on s. 31(2)(a). The SC Leave Court's decision quotes a lengthy passage from *BCIT* that focuses on the requirements of s. 31(2)(a). The SC Leave Court judge noted that both parties conceded the first requirement of s. 31(2)(a): that the issue be of importance to the parties. The CA Leave Court decision expressed concern that denying leave might give rise to a miscarriage of justice — a criterion only found in s. 31(2)(a). Finally, neither the lower courts' leave decisions nor the arguments before this Court reflected arguments about the question of law being important to some class or body of persons of which the applicant is a member (s. 31(2)(b)) or being a point of law of general or public importance (s. 31(2)(c)). Accordingly, the following analysis will focus on s. 31(2)(a).

*(2) The Result Is Important to the Parties*

41 In order for leave to be granted from a commercial arbitral award, a threshold requirement must be met: leave must be sought on a question of law. However, before dealing with that issue, it will be convenient to quickly address another requirement of s. 31(2)(a) on which the parties agree: whether the importance of the result of the arbitration to the parties justifies the intervention of the court. Justice Saunders explained this criterion in *BCIT* as requiring that the result of the arbitration be "sufficiently important", in terms of principle or money, to the parties to justify the expense and time of court proceedings (para. 27). The parties in this case have agreed that the result of the arbitration is of importance to each of them. In view of the relatively large monetary amount in dispute and in light of the fact that the parties have agreed that the result is important to them, I accept that the importance of the result of the arbitration to the parties justifies the intervention of the court. This requirement of s. 31(2)(a) is satisfied.

*(3) The Question Under Appeal Is Not a Question of Law*

**(a) When Is Contractual Interpretation a Question of Law?**

42 Under s. 31 of the *AA*, the issue upon which leave is sought must be a question of law. For the purpose of identifying the appropriate standard of review or, as is the case here, determining whether the requirements for leave to appeal are met, reviewing courts are regularly required to determine whether an issue decided at first instance is a question of law, fact, or mixed fact and law.

43 Historically, determining the legal rights and obligations of the parties under a written contract was considered a question of law (*King v. Operating Engineers Training Institute of Manitoba Inc.*, 2011 MBCA 80, 270 Man. R. (2d) 63 (Man. C.A.), at para. 20, *per* Steel J.A.; K. Lewison, *The Interpretation of Contracts* (5th ed. 2011 & Supp. 2013), at pp. 173-76; and G. R. Hall, *Canadian Contractual Interpretation Law* (2nd ed. 2012), at pp. 125-26). This rule originated in England at a time when there were frequent civil jury trials and widespread illiteracy. Under those circumstances, the interpretation of written documents had to be considered questions of law because only the judge could be assured to be literate and therefore capable of reading the contract (Hall, at p. 126; and Lewison, at pp. 173-74).

44 This historical rationale no longer applies. Nevertheless, courts in the United Kingdom continue to treat the interpretation of a written contract as always being a question of law (*Thorner v. Major*, [2009] UKHL 18, [2009] 3 All E.R. 945 (U.K. H.L.), at paras. 58 and 82-83; and Lewison, at pp. 173-77). They do this despite the fact that U.K. courts consider the surrounding circumstances, a concept addressed further below, when interpreting a written contract (*Prenn v. Simmonds*, [1971] 3 All E.R. 237 (U.K. H.L.); and *Reardon Smith Line v. Hansen-Tangen*, [1976] 3 All E.R. 570 (U.K. H.L.)).

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45 In Canada, there remains some support for the historical approach. See for example *Jiro Enterprises Ltd. v. Spencer*, 2008 ABCA 87 (Alta. C.A.) (CanLII), at para. 10; *QK Investments Inc. v. Crocus Investment Fund*, 2008 MBCA 21, 290 D.L.R. (4th) 84 (Man. C.A.), at para. 26; *Dow Chemical Canada Inc. v. Shell Chemicals Canada Ltd.*, 2010 ABCA 126, 25 Alta. L.R. (5th) 221 (Alta. C.A.), at paras. 11-12; and *Costco Wholesale Canada Ltd. v. R.*, 2012 FCA 160, 431 N.R. 78 (F.C.A.), at para. 34. However, some Canadian courts have abandoned the historical approach and now treat the interpretation of written contracts as an exercise involving either a question of law or a question of mixed fact and law. See for example *WCI Waste Conversion Inc. v. ADI International Inc.*, 2011 PECA 14, 309 Nfld. & P.E.I.R. 1 (P.E.I. C.A.), at para. 11; *269893 Alberta Ltd. v. Otter Bay Developments Ltd.*, 2009 BCCA 37, 266 B.C.A.C. 98 (B.C. C.A.), at para. 13; *Hayes Forest Services Ltd. v. Weyerhaeuser Co.*, 2008 BCCA 31, 289 D.L.R. (4th) 230 (B.C. C.A.), at para. 44; *Plan Group v. Bell Canada*, 2009 ONCA 548, 96 O.R. (3d) 81 (Ont. C.A.), at paras. 22-23 (majority reasons, *per* Blair J.A.) and paras. 133-35 (*per* Gillese J.A. in dissent, but not on this point); and *King*, at paras. 20-23.

46 The shift away from the historical approach in Canada appears to be based on two developments. The first is the adoption of an approach to contractual interpretation which directs courts to have regard for the surrounding circumstances of the contract — often referred to as the factual matrix — when interpreting a written contract (Hall, at pp. 13, 21-25 and 127; and J. D. McCamus, *The Law of Contracts* (2nd ed. 2012), at pp. 749-51). The second is the explanation of the difference between questions of law and questions of mixed fact and law provided in *Canada (Director of Investigation & Research) v. Southam Inc.*, [1997] 1 S.C.R. 748 (S.C.C.), at para. 35, and *Housen v. Nikolaisen*, 2002 SCC 33, [2002] 2 S.C.R. 235 (S.C.C.), at paras. 26 and 31-36.

47 Regarding the first development, the interpretation of contracts has evolved towards a practical, common-sense approach not dominated by technical rules of construction. The overriding concern is to determine "the intent of the parties and the scope of their understanding" (*Jesuit Fathers of Upper Canada v. Guardian Insurance Co. of Canada*, 2006 SCC 21, [2006] 1 S.C.R. 744 (S.C.C.), at para. 27 *per* LeBel J.; see also *Tercon Contractors Ltd. v. British Columbia (Minister of Transportation & Highways)*, 2010 SCC 4, [2010] 1 S.C.R. 69 (S.C.C.), at paras. 64-65 *per* Cromwell J.). To do so, a decision-maker must read the contract as a whole, giving the words used their ordinary and grammatical meaning, consistent with the surrounding circumstances known to the parties at the time of formation of the contract. Consideration of the surrounding circumstances recognizes that ascertaining contractual intention can be difficult when looking at words on their own, because words alone do not have an immutable or absolute meaning:

> No contracts are made in a vacuum: there is always a setting in which they have to be placed.... In a commercial contract it is certainly right that the court should know the commercial purpose of the contract and this in turn presupposes knowledge of the genesis of the transaction, the background, the context, the market in which the parties are operating.
>
> (*Reardon Smith Line*, at p. 574, *per* Lord Wilberforce)

48 The meaning of words is often derived from a number of contextual factors, including the purpose of the agreement and the nature of the relationship created by the agreement (see *Geoffrey L. Moore Realty Inc. v. Manitoba Motor League*, 2003 MBCA 71, 173 Man. R. (2d) 300 (Man. C.A.), at para. 15, *per* Hamilton J.A.; see also Hall, at p. 22; and McCamus, at pp. 749-50). As stated by Lord Hoffmann in *Investors Compensation Scheme Ltd. v. West Bromwich Building Society* (1997), [1998] 1 All E.R. 98 (U.K. H.L.):

> The meaning which a document (or any other utterance) would convey to a reasonable man is not the same thing as the meaning of its words. The meaning of words is a matter of dictionaries and grammars; the meaning of the document is what the parties using those words against the relevant background would reasonably have been understood to mean. [p. 115]

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49 As to the second development, the historical approach to contractual interpretation does not fit well with the definition of a pure question of law identified in *Housen* and *Southam Inc*. Questions of law "are questions about what the correct legal test is" (*Southam Inc.*, at para. 35). Yet in contractual interpretation, the goal of the exercise is to ascertain the objective intent of the parties — a fact-specific goal — through the application of legal principles of interpretation. This appears closer to a question of mixed fact and law, defined in *Housen* as "applying a legal standard to a set of facts" (para. 26; see also *Southam Inc.*, at para. 35). However, some courts have questioned whether this definition, which was developed in the context of a negligence action, can be readily applied to questions of contractual interpretation, and suggest that contractual interpretation is primarily a legal affair (see for example *Bell Canada*, at para. 25).

50 With respect for the contrary view, I am of the opinion that the historical approach should be abandoned. Contractual interpretation involves issues of mixed fact and law as it is an exercise in which the principles of contractual interpretation are applied to the words of the written contract, considered in light of the factual matrix.

51 The purpose of the distinction between questions of law and those of mixed fact and law further supports this conclusion. One central purpose of drawing a distinction between questions of law and those of mixed fact and law is to limit the intervention of appellate courts to cases where the results can be expected to have an impact beyond the parties to the particular dispute. It reflects the role of courts of appeal in ensuring the consistency of the law, rather than in providing a new forum for parties to continue their private litigation. For this reason, *Southam Inc.* identified the degree of generality (or "precedential value") as the key difference between a question of law and a question of mixed fact and law. The more narrow the rule, the less useful will be the intervention of the court of appeal:

> If a court were to decide that driving at a certain speed on a certain road under certain conditions was negligent, its decision would not have any great value as a precedent. In short, as the level of generality of the challenged proposition approaches utter particularity, the matter approaches pure application, and hence draws nigh to being an unqualified question of mixed law and fact. See R. P. Kerans, *Standards of Review Employed by Appellate Courts* (1994), at pp. 103-108. Of course, it is not easy to say precisely where the line should be drawn; though in most cases it should be sufficiently clear whether the dispute is over a general proposition that might qualify as a principle of law or over a very particular set of circumstances that is not apt to be of much interest to judges and lawyers in the future. [para. 37]

52 Similarly, this Court in *Housen* found that deference to fact-finders promoted the goals of limiting the number, length, and cost of appeals, and of promoting the autonomy and integrity of trial proceedings (paras. 16-17). These principles also weigh in favour of deference to first instance decision-makers on points of contractual interpretation. The legal obligations arising from a contract are, in most cases, limited to the interest of the particular parties. Given that our legal system leaves broad scope to tribunals of first instance to resolve issues of limited application, this supports treating contractual interpretation as a question of mixed fact and law.

53 Nonetheless, it may be possible to identify an extricable question of law from within what was initially characterized as a question of mixed fact and law (*Housen*, at paras. 31 and 34-35). Legal errors made in the course of contractual interpretation include "the application of an incorrect principle, the failure to consider a required element of a legal test, or the failure to consider a relevant factor" (*King*, at para. 21). Moreover, there is no question that many other issues in contract law do engage substantive rules of law: the requirements for the formation of the contract, the capacity of the parties, the requirement that certain contracts be evidenced in writing, and so on.

54 However, courts should be cautious in identifying extricable questions of law in disputes over contractual interpretation. Given the statutory requirement to identify a question of law in a leave application pursuant to s. 31(2) of the *AA*, the applicant

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for leave and its counsel will seek to frame any alleged errors as questions of law. The legislature has sought to restrict such appeals, however, and courts must be careful to ensure that the proposed ground of appeal has been properly characterized. The warning expressed in *Housen* to exercise caution in attempting to extricate a question of law is relevant here:

> Appellate courts must be cautious, however, in finding that a trial judge erred in law in his or her determination of negligence, as it is often difficult to extricate the legal questions from the factual. It is for this reason that these matters are referred to as questions of “mixed law and fact”. Where the legal principle is not readily extricable, then the matter is one of “mixed law and fact” .... [para. 36]

55 Although that caution was expressed in the context of a negligence case, it applies, in my opinion, to contractual interpretation as well. As mentioned above, the goal of contractual interpretation, to ascertain the objective intentions of the parties, is inherently fact specific. The close relationship between the selection and application of principles of contractual interpretation and the construction ultimately given to the instrument means that the circumstances in which a question of law can be extricated from the interpretation process will be rare. In the absence of a legal error of the type described above, no appeal lies under the *AA* from an arbitrator’s interpretation of a contract.

**(b) The Role and Nature of the “Surrounding Circumstances”**

56 I now turn to the role of the surrounding circumstances in contractual interpretation and the nature of the evidence that can be considered. The discussion here is limited to the common law approach to contractual interpretation; it does not seek to apply to or alter the law of contractual interpretation governed by the *Civil Code of Québec*.

57 While the surrounding circumstances will be considered in interpreting the terms of a contract, they must never be allowed to overwhelm the words of that agreement (*Hayes Forest Services*, at para. 14; and Hall, at p. 30). The goal of examining such evidence is to deepen a decision-maker’s understanding of the mutual and objective intentions of the parties as expressed in the words of the contract. The interpretation of a written contractual provision must always be grounded in the text and read in light of the entire contract (Hall, at pp. 15 and 30-32). While the surrounding circumstances are relied upon in the interpretive process, courts cannot use them to deviate from the text such that the court effectively creates a new agreement (*Glaswegian Enterprises Inc. v. BC Tel Mobility Cellular Inc.* (1997), 101 B.C.A.C. 62 (B.C. C.A.)).

58 The nature of the evidence that can be relied upon under the rubric of “surrounding circumstances” will necessarily vary from case to case. It does, however, have its limits. It should consist only of objective evidence of the background facts at the time of the execution of the contract (*King*, at paras. 66 and 70), that is, knowledge that was or reasonably ought to have been within the knowledge of both parties at or before the date of contracting. Subject to these requirements and the parol evidence rule discussed below, this includes, in the words of Lord Hoffmann, “absolutely anything which would have affected the way in which the language of the document would have been understood by a reasonable man” (*Investors Compensation Scheme*, at p. 114). Whether something was or reasonably ought to have been within the common knowledge of the parties at the time of execution of the contract is a question of fact.

**(c) Considering the Surrounding Circumstances Does Not Offend the Parol Evidence Rule**

59 It is necessary to say a word about consideration of the surrounding circumstances and the parol evidence rule. The parol evidence rule precludes admission of evidence outside the words of the written contract that would add to, subtract from, vary,

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or contradict a contract that has been wholly reduced to writing (*King*, at para. 35; and Hall, at p. 53). To this end, the rule precludes, among other things, evidence of the subjective intentions of the parties (Hall, at pp. 64-65; and *Eli Lilly & Co. v. Novopharm Ltd.*, [1998] 2 S.C.R. 129 (S.C.C.), at paras. 54-59, *per* Iacobucci J.). The purpose of the parol evidence rule is primarily to achieve finality and certainty in contractual obligations, and secondarily to hamper a party's ability to use fabricated or unreliable evidence to attack a written contract (*C.J.A., Local 579 v. Bradco Construction Ltd.*, [1993] 2 S.C.R. 316 (S.C.C.), at pp. 341-42, *per* Sopinka J.).

60 The parol evidence rule does not apply to preclude evidence of the surrounding circumstances. Such evidence is consistent with the objectives of finality and certainty because it is used as an interpretive aid for determining the meaning of the written words chosen by the parties, not to change or overrule the meaning of those words. The surrounding circumstances are facts known or facts that reasonably ought to have been known to both parties at or before the date of contracting; therefore, the concern of unreliability does not arise.

61 Some authorities and commentators suggest that the parol evidence rule is an anachronism, or, at the very least, of limited application in view of the myriad of exceptions to it (see for example *Gutierrez v. Tropic International Ltd.* (2002), 63 O.R. (3d) 63 (Ont. C.A.), at paras. 19-20; and Hall, at pp. 53-64). For the purposes of this appeal, it is sufficient to say that the parol evidence rule does not apply to preclude evidence of surrounding circumstances when interpreting the words of a written contract.

**(d) Application to the Present Case**

62 In this case, the CA Leave Court granted leave on the following issue: "Whether the Arbitrator erred in law in failing to construe the whole of the Finder's Fee Agreement ..." (A.R., vol. 1, at p. 62).

63 As will be explained below, while the requirement to construe a contract as a whole is a question of law that could — if extricable — satisfy the threshold requirement under s. 31 of the *AA*, I do not think this question was properly extricated in this case.

64 I accept that a fundamental principle of contractual interpretation is that a contract must be construed as a whole (McCamus, at pp. 761-62; and Hall, at p. 15). If the arbitrator did not take the "maximum amount" proviso into account, as alleged by Creston, then he did not construe the Agreement as a whole because he ignored a specific and relevant provision of the Agreement. This is a question of law that would be extricable from a finding of mixed fact and law.

65 However, it appears that the arbitrator did consider the "maximum amount" proviso. Indeed, the CA Leave Court acknowledges that the arbitrator had considered that proviso, since it notes that he turned his mind to the US$1.5 million maximum amount, an amount that can only be calculated by referring to the TSXV policy referenced in the "maximum amount" proviso in s. 3.1 of the Agreement. As I read its reasons, rather than being concerned with whether the arbitrator ignored the maximum amount proviso, which is what Creston alleges in this Court, the CA Leave Court decision focused on how the arbitrator construed s. 3.1 of the Agreement, which included the maximum amount proviso (paras. 25-26). For example, the CA Leave Court expressed concern that the arbitrator did not address the "incongruity" in the fact that the value of the fee would vary "hugely" depending on whether it was taken in cash or shares (para. 25).

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66 With respect, the CA Leave Court erred in finding that the construction of s. 3.1 of the Agreement constituted a question of law. As explained by Justice Armstrong in the SC Appeal Court decision, construing s. 3.1 and taking account of the proviso required relying on the relevant surrounding circumstances, including the sophistication of the parties, the fluctuation in share prices, and the nature of the risk a party assumes when deciding to accept a fee in shares as opposed to cash. Such an exercise raises a question of mixed fact and law. There being no question of law extricable from the mixed fact and law question of how s. 3.1 and the proviso should be interpreted, the CA Leave Court erred in granting leave to appeal.

67 The conclusion that Creston's application for leave to appeal raised no question of law would be sufficient to dispose of this appeal. However, as this Court rarely has the opportunity to address appeals of arbitral awards, it is, in my view, useful to explain that, even had the CA Leave Court been correct in finding that construction of s. 3.1 of the Agreement constituted a question of law, it should have nonetheless denied leave to appeal as the application also failed the miscarriage of justice and residual discretion stages of the leave analysis set out in s. 31(2)(a) of the *AA*.

*(4) May Prevent a Miscarriage of Justice*

**(a) Miscarriage of Justice for the Purposes of Section 31(2)(a) of the AA**

68 Once a question of law has been identified, the court must be satisfied that the determination of that point of law on appeal "may prevent a miscarriage of justice" in order for it to grant leave to appeal pursuant to s. 31(2)(a) of the *AA*. The first step in this analysis is defining miscarriage of justice for the purposes of s. 31(2)(a).

69 In *BCIT*, Justice Saunders discussed the miscarriage of justice requirement under s. 31(2)(a). She affirmed the definition set out in *Domtar Inc. v. Belkin Inc.* (1989), 39 B.C.L.R. (2d) 257 (B.C. C.A.), which required the error of law in question to be a material issue that, if decided differently, would lead to a different result: "... if the point of law were decided differently, the arbitrator would have been led to a different result. In other words, was the alleged error of law material to the decision; does it go to its heart?" (*BCIT*, at para. 28). See also *Cusson v. Quan*, 2009 SCC 62, [2009] 3 S.C.R. 712 (S.C.C.), which discusses the test of whether "some substantial wrong or miscarriage of justice has occurred" in the context of a civil jury trial (para. 43).

70 Having regard to *BCIT* and *Quan*, I am of the opinion that in order to rise to the level of a miscarriage of justice for the purposes of s. 31(2)(a) of the *AA*, an alleged legal error must pertain to a material issue in the dispute which, if decided differently, would affect the result of the case.

71 According to this standard, a determination of a point of law "may prevent a miscarriage of justice" only where the appeal itself has some possibility of succeeding. An appeal with no chance of success will not meet the threshold of "may prevent a miscarriage of justice" because there would be no chance that the outcome of the appeal would cause a change in the final result of the case.

72 At the leave stage, it is not appropriate to consider the full merits of a case and make a final determination regarding whether an error of law was made. However, some preliminary consideration of the question of law is necessary to determine whether the appeal has the potential to succeed and thus to change the result in the case.

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73 *BCIT* sets the threshold for this preliminary assessment of the appeal as "more than an arguable point" (para. 30). With respect, once an arguable point has been made out, it is not apparent what more is required to meet the "more than an arguable point" standard. Presumably, the leave judge would have to delve more deeply into the arguments around the question of law on appeal than would be appropriate at the leave stage to find *more* than an arguable point. Requiring this closer examination of the point of law, in my respectful view, blurs the line between the function of the court considering the leave application and the court hearing the appeal.

74 In my opinion, the appropriate threshold for assessing the legal question at issue under s. 31(2) is whether it has arguable merit. The arguable merit standard is often used to assess, on a preliminary basis, the merits of an appeal at the leave stage (see for example *Quick Auto Lease Inc. v. Nordin*, 2014 MBCA 32, 303 Man. R. (2d) 262 (Man. C.A.), at para. 5; and *R. v. Fedossenko*, 2013 ABCA 164 (Alta. C.A.) (CanLII), at para. 7). "Arguable merit" is a well-known phrase whose meaning has been expressed in a variety of ways: "a reasonable prospect of success" (*Quick Auto Lease Inc.*, at para. 5; and *Enns v. Hansey*, 2013 MBCA 23 (Man. C.A.) (CanLII), at para. 2); "some hope of success" and "sufficient merit" (*R. v. Hubley*, 2009 PECA 21, 289 Nfld. & P.E.I.R. 174 (P.E.I. C.A.), at para. 11); and "credible argument" (*R. v. Will*, 2013 SKCA 4, 405 Sask. R. 270 (Sask. C.A. [In Chambers]), at para. 8). In my view, the common thread among the various expressions used to describe arguable merit is that the issue raised by the applicant cannot be dismissed through a preliminary examination of the question of law. In order to decide whether the award should be set aside, a more thorough examination is necessary and that examination is appropriately conducted by the court hearing the appeal once leave is granted.

75 Assessing whether the issue raised by an application for leave to appeal has arguable merit must be done in light of the standard of review on which the merits of the appeal will be judged. This requires a preliminary assessment of the applicable standard of review. As I will later explain, reasonableness will almost always apply to commercial arbitrations conducted pursuant to the *AA*, except in the rare circumstances where the question is one that would attract a correctness standard, such as a constitutional question or a question of law of central importance to the legal system as a whole and outside the adjudicator's expertise. Therefore, the leave inquiry will ordinarily ask whether there is any arguable merit to the position that the arbitrator's decision on the question at issue is unreasonable, keeping in mind that the decision-maker is not required to refer to all the arguments, provisions or jurisprudence or to make specific findings on each constituent element, for the decision to be reasonable (*N.L.N.U. v. Newfoundland & Labrador (Treasury Board)*, 2011 SCC 62, [2011] 3 S.C.R. 708 (S.C.C.), at para. 16). Of course, the leave court's assessment of the standard of review is only preliminary and does not bind the court which considers the merits of the appeal. As such, this should not be taken as an invitation to engage in extensive arguments or analysis about the standard of review at the leave stage.

76 In *BCIT*, Saunders J.A. considered the stage of s. 31(2)(a) of the *AA* at which an examination of the merits of the appeal should occur. At the behest of one of the parties, she considered examining the merits under the miscarriage of justice criterion. However, she decided that a consideration of the merits was best done at the residual discretion stage. Her reasons indicate that this decision was motivated by the desire to take a consistent approach across s. 31(2)(a), (b) and (c):

> Where, then, if anywhere, does consideration of the merits of the appeal belong? Mr. Roberts for the Student Association contends that any consideration of the merits of the appeal belongs in the determination of whether a miscarriage of justice may occur; that is, under the second criterion. I do not agree. In my view, the apparent merit or lack of merit of an appeal is part of the exercise of the residual discretion, and applies equally to all three subsections, (*a*) through (*c*). Just as an appeal woefully lacking in merit should not attract leave under (*b*) (of importance to a class of people including the applicant) or (*c*) (of general or public importance), so too it should not attract leave under (*a*). Consideration of the merits, for consistency in the section as a whole, should be made as part of the exercise of residual discretion. [para. 29]

77 I acknowledge the consistency rationale. However, in my respectful opinion, the desire for a consistent approach to s. 31(2)(a), (b) and (c) cannot override the text of the legislation. Unlike s. 31(2)(b) and (c), s. 31(2)(a) requires an assessment to

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determine whether allowing leave to appeal "may prevent a miscarriage of justice". It is my opinion that a preliminary assessment of the question of law is an implicit component in a determination of whether allowing leave "may prevent a miscarriage of justice".

78 However, in an application for leave to appeal pursuant to s. 31(2)(b) or (c), neither of which contain a miscarriage of justice requirement, I agree with Justice Saunders in *BCIT* that a preliminary examination of the merits of the question of law should be assessed at the residual discretion stage of the analysis as considering the merits of the proposed appeal will always be relevant when deciding whether to grant leave to appeal under s. 31.

79 In sum, in order to establish that "the intervention of the court and the determination of the point of law may prevent a miscarriage of justice" for the purposes of s. 31(2)(a) of the *AA*, an applicant must demonstrate that the point of law on appeal is material to the final result and has arguable merit.

**(b) Application to the Present Case**

80 The CA Leave Court found that the arbitrator may have erred in law by not interpreting the Agreement as a whole, specifically in ignoring the "maximum amount" proviso. Accepting that this is a question of law for these purposes only, a determination of the question would be material because it could change the ultimate result arrived at by the arbitrator. The arbitrator awarded $4.14 million in damages on the basis that there was an 85 percent chance the TSXV would approve a finder's fee paid in $0.15 shares. If Creston's argument is correct and the $0.15 share price is foreclosed by the "maximum amount" proviso, damages would be reduced to US$1.5 million, a significant reduction from the arbitrator's award of damages.

81 As s. 31(2)(a) of the *AA* is the relevant provision in this case, a preliminary assessment of the question of law will be conducted in order to determine if a miscarriage of justice could have occurred had Creston been denied leave to appeal. Creston argues that the fact that the arbitrator's conclusion results in Sattva receiving shares valued at considerably more than the US$1.5 million maximum dictated by the "maximum amount" proviso is evidence of the arbitrator's failure to consider that proviso.

82 However, the arbitrator did refer to s. 3.1, the "maximum amount" proviso, at two points in his decision: paras. 18 and 23(a). For example, at para. 23 he stated:

> In summary, then, as of March 27, 2007 it was clear and beyond argument that under the Agreement:
>
> > (a) <u>Sattva was entitled to a fee equal to the maximum amount payable pursuant to the rules and policies of the TSX Venture Exchange — section 3.1. It is common ground that the quantum of this fee is US$1,500,000.</u>
> >
> > (b) The fee was payable in shares based on the Market Price, as defined in the Agreement, unless Sattva elected to take it in cash or a combination of cash and shares.
> >
> > (c) The Market Price, as defined in the Agreement, was $0.15.
>
> [Emphasis added.]

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83 Although the arbitrator provided no express indication that he considered how the "maximum amount" proviso interacted with the Market Price definition, such consideration is implicit in his decision. The only place in the contract that specifies that the amount of the fee is calculated as US$1.5 million is the "maximum amount" proviso's reference to s. 3.3 of the TSXV Policy 5.1. The arbitrator acknowledged that the quantum of the fee is US$1.5 million and awarded Sattva US$1.5 million in shares priced at $0.15. Contrary to Creston's argument that the arbitrator failed to consider the proviso in construing the Agreement, it is apparent on a preliminary examination of the question that the arbitrator did in fact consider the "maximum amount" proviso.

84 Accordingly, even had the CA Leave Court properly identified a question of law, leave to appeal should have been denied. The requirement that there be arguable merit that the arbitrator's decision was unreasonable is not met and the miscarriage of justice threshold was not satisfied.

*(5) Residual Discretion to Deny Leave*

**(a) Considerations in Exercising Residual Discretion in a Section 31(2)(a) Leave Application**

85 The B.C. courts have found that the words "may grant leave" in s. 31(2) of the *AA* confer on the court residual discretion to deny leave even where the requirements of s. 31(2) are met (*BCIT*, at paras. 9 and 26). In *BCIT*, Saunders J.A. sets out a non-exhaustive list of considerations that would be applicable to the exercise of discretion (para. 31):

1. "the apparent merits of the appeal";
2. "the degree of significance of the issue to the parties, to third parties and to the community at large";
3. "the circumstances surrounding the dispute and adjudication including the urgency of a final answer";
4. "other temporal considerations including the opportunity for either party to address the result through other avenues";
5. "the conduct of the parties";
6. "the stage of the process at which the appealed decision was made";
7. "respect for the forum of arbitration, chosen by the parties as their means of resolving disputes"; and
8. "recognition that arbitration is often intended to provide a speedy and final dispute mechanism, tailor-made for the issues which may face the parties to the arbitration agreement".

86 I agree with Justice Saunders that it is not appropriate to create what she refers to as an "immutable checklist" of factors to consider in exercising discretion under s. 31(2) (*BCIT*, at para. 32). However, I am unable to agree that all the listed considerations are applicable at this stage of the analysis.

87 In exercising its statutorily conferred discretion to deny leave to appeal pursuant to s. 31(2)(a), a court should have regard to the traditional bases for refusing discretionary relief: the parties' conduct, the existence of alternative remedies, and any undue delay (*Immeubles Port Louis Ltée c. Lafontaine (Village)*, [1991] 1 S.C.R. 326 (S.C.C.), at pp. 364-67). Balance of

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convenience considerations are also involved in determining whether to deny discretionary relief (*MiningWatch Canada v. Canada (Minister of Fisheries & Oceans)*, 2010 SCC 2, [2010] 1 S.C.R. 6 (S.C.C.), at para. 52). This would include the urgent need for a final answer.

88 With respect to the other listed considerations and addressed in turn below, it is my opinion that they have already been considered elsewhere in the s. 31(2)(a) analysis or are more appropriately considered elsewhere under s. 31(2). Once considered, these matters should not be assessed again under the court's residual discretion.

89 As discussed above, in s. 31(2)(a), a preliminary assessment of the merits of the question of law at issue in the leave application is to be considered in determining the miscarriage of justice question. The degree of significance of the issue to the parties is covered by the "importance of the result of the arbitration to the parties" criterion in s. 31(2)(a). The degree of significance of the issue to third parties and to the community at large should not be considered under s. 31(2)(a) as the *AA* sets these out as separate grounds for granting leave to appeal under s. 31(2)(b) and (c). Furthermore, respect for the forum of arbitration chosen by the parties is a consideration that animates the legislation itself and can be seen in the high threshold to obtain leave under s. 31(2)(a). Recognition that arbitration is often chosen as a means to obtain a fast and final resolution tailor-made for the issues is already reflected in the urgent need for a final answer.

90 As for the stage of the process at which the decision sought to be appealed was made, it is not a consideration relevant to the exercise of the court's residual discretion to deny leave under s. 31(2)(a). This factor seeks to address the concern that granting leave to appeal an interlocutory decision may be premature and result in unnecessary fragmentation and delay of the legal process (D. J. M. Brown and J. M. Evans, with the assistance of C. E. Deacon, *Judicial Review of Administrative Action in Canada* (loose-leaf), at pp. 3-67 to 3-76). However, any such concern will have been previously addressed by the leave court in its analysis of whether a miscarriage of justice may arise; more specifically, whether the interlocutory issue has the potential to affect the final result. As such, the above-mentioned concerns should not be considered anew.

91 In sum, a non-exhaustive list of discretionary factors to consider in a leave application under s. 31(2)(a) of the *AA* would include:

- conduct of the parties;
- existence of alternative remedies;
- undue delay; and
- the urgent need for a final answer.

92 These considerations could, where applicable, be a sound basis for declining leave to appeal an arbitral award even where the statutory criteria of s. 31(2)(a) have been met. However, courts should exercise such discretion with caution. Having found an error of law and, at least with respect to s. 31(2)(a), a potential miscarriage of justice, these discretionary factors must be weighed carefully before an otherwise eligible appeal is rejected on discretionary grounds.

**(b) Application to the Present Case**

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93 The SC Leave Court judge denied leave on the basis that there was no question of law. Even had he found a question of law, the SC Leave Court judge stated that he would have exercised his residual discretion to deny leave for two reasons: first, because of Creston's conduct in misrepresenting the status of the finder's fee issue to the TSXV and Sattva; and second, "on the principle that one of the objectives of the [*AA*] is to foster and preserve the integrity of the arbitration system" (para. 41). The CA Leave Court overruled the SC Leave Court on both of these discretionary grounds.

94 For the reasons discussed above, fostering and preserving the integrity of the arbitral system should not be a discrete discretionary consideration under s. 31(2)(a). While the scheme of s. 31(2) recognizes this objective, the exercise of discretion must pertain to the facts and circumstances of a particular case. This general objective is not a discretionary matter for the purposes of denying leave.

95 However, conduct of the parties is a valid consideration in the exercise of the court's residual discretion under s. 31(2)(a). A discretionary decision to deny leave is to be reviewed with deference by an appellate court. A discretionary decision should not be interfered with merely because an appellate court would have exercised the discretion differently (*R. c. Bellusci*, 2012 SCC 44, [2012] 2 S.C.R. 509 (S.C.C.), at paras. 18 and 30). An appellate court is only justified in interfering with a lower court judge's exercise of discretion if that judge misdirected himself or if his decision is so clearly wrong as to amount to an injustice (*R. v. Bjelland*, 2009 SCC 38, [2009] 2 S.C.R. 651 (S.C.C.), at para. 15; and *R. v. Regan*, 2002 SCC 12, [2002] 1 S.C.R. 297 (S.C.C.), at para. 117).

96 Here, the SC Leave Court relied upon a well-accepted consideration in deciding to deny discretionary relief: the misconduct of Creston. The CA Leave Court overturned this decision on the grounds that Creston's conduct was "not directly relevant to the question of law" advanced on appeal (at para. 27).

97 The CA Leave Court did not explain why misconduct need be directly relevant to a question of law for the purpose of denying leave. I see nothing in s. 31(2) of the *AA* that would limit a leave judge's exercise of discretion in the manner suggested by the CA Leave Court. My reading of the jurisprudence does not support the view that misconduct must be directly relevant to the question to be decided by the court.

98 In *Homex Realty & Development Co. v. Wyoming (Village)*, [1980] 2 S.C.R. 1011 (S.C.C.), at pp. 1037-38, misconduct by a party not directly relevant to the question at issue before the court resulted in denial of a remedy. The litigation in *Homex* arose out of a disagreement regarding whether the purchaser of lots in a subdivision, Homex, had assumed the obligations of the vendor under a subdivision agreement to provide "all the requirements, financial and otherwise" for the installation of municipal services on a parcel of land that had been subdivided (pp. 1015-16). This Court determined that Homex had not been accorded procedural fairness when the municipality passed a by-law related to the dispute (p. 1032). Nevertheless, discretionary relief to quash the by-law was denied because, among other things, Homex had sought "throughout all these proceedings to avoid the burden associated with the subdivision of the lands" that it owned (p. 1037), even though the Court held that Homex knew this obligation was its responsibility (pp. 1017-19). This conduct was related to the dispute that gave rise to the litigation, but not to the question of whether the by-law was enacted in a procedurally fair manner. Accordingly, I read *Homex* as authority for the proposition that misconduct related to the dispute that gave rise to the proceedings may justify the exercise of discretion to refuse the relief sought, in this case refusing to grant leave to appeal.

99 Here, the arbitrator found as a fact that Creston misled the TSXV and Sattva regarding "the nature of the obligation it had undertaken to Sattva by representing that the finder's fee was payable in cash" (para. 56(k)). While this conduct is not tied to the question of law found by the CA Leave Court, it is tied to the arbitration proceeding convened to determine which share price

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should be used to pay Sattva's finder's fee. The SC Leave Court was entitled to rely upon such conduct as a basis for denying leave pursuant to its residual discretion.

100 In the result, in my respectful opinion, even if the CA Leave Court had identified a question of law and the miscarriage of justice test had been met, it should have upheld the SC Leave Court's denial of leave to appeal in deference to that court's exercise of judicial discretion.

101 Although the CA Leave Court erred in granting leave, these protracted proceedings have nonetheless now reached this Court. In light of the fact that the true concern between the parties is the merits of the appeal — that is how much the Agreement requires Creston to pay Sattva — and that the courts below differed significantly in their interpretation of the Agreement, it would be unsatisfactory not to address the very dispute that has given rise to these proceedings. I will therefore proceed to consider the three remaining questions on appeal as if leave to appeal had been properly granted.

***C. Standard of Review Under the AA***

102 I now turn to consideration of the decisions of the appeal courts. It is first necessary to determine the standard of review of the arbitrator's decision in respect of the question on which the CA Leave Court granted leave: whether the arbitrator construed the finder's fee provision in light of the Agreement as a whole, particularly, whether the finder's fee provision was interpreted having regard for the "maximum amount" proviso.

103 At the outset, it is important to note that the *Administrative Tribunals Act*, S.B.C. 2004, c. 45, which sets out standards of review of the decisions of many statutory tribunals in British Columbia (see ss. 58 and 59), does not apply in the case of arbitrations under the *AA*.

104 Appellate review of commercial arbitration awards takes place under a tightly defined regime specifically tailored to the objectives of commercial arbitrations and is different from judicial review of a decision of a statutory tribunal. For example, for the most part, parties engage in arbitration by mutual choice, not by way of a statutory process. Additionally, unlike statutory tribunals, the parties to the arbitration select the number and identity of the arbitrators. These differences mean that the judicial review framework developed in *New Brunswick (Board of Management) v. Dunsmuir*, 2008 SCC 9, [2008] 1 S.C.R. 190 (S.C.C.), and the cases that followed it is not entirely applicable to the commercial arbitration context. For example, the *AA* forbids review of an arbitrator's factual findings. In the context of commercial arbitration, such a provision is absolute. Under the *Dunsmuir* judicial review framework, a privative clause does not prevent a court from reviewing a decision, it simply signals deference (*Dunsmuir*, at para. 31).

105 Nevertheless, judicial review of administrative tribunal decisions and appeals of arbitration awards are analogous in some respects. Both involve a court reviewing the decision of a non-judicial decision-maker. Additionally, as expertise is a factor in judicial review, it is a factor in commercial arbitrations: where parties choose their own decision-maker, it may be presumed that such decision-makers are chosen either based on their expertise in the area which is the subject of dispute or are otherwise qualified in a manner that is acceptable to the parties. For these reasons, aspects of the *Dunsmuir* framework are helpful in determining the appropriate standard of review to apply in the case of commercial arbitration awards.

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106 *Dunsmuir* and the post-*Dunsmuir* jurisprudence confirm that it will often be possible to determine the standard of review by focusing on the nature of the question at issue (see for example *A.T.A. v. Alberta (Information & Privacy Commissioner)*, 2011 SCC 61, [2011] 3 S.C.R. 654 (S.C.C.), at para. 44). In the context of commercial arbitration, where appeals are restricted to questions of law, the standard of review will be reasonableness unless the question is one that would attract the correctness standard, such as constitutional questions or questions of law of central importance to the legal system as a whole and outside the adjudicator's expertise (*A.T.A.*, at para. 30). The question at issue here, whether the arbitrator interpreted the Agreement as a whole, does not fall into one of those categories. The relevant portions of the *Dunsmuir* analysis point to a standard of review of reasonableness in this case.

***D. The Arbitrator Reasonably Construed the Agreement as a Whole***

107 For largely the reasons outlined by Justice Armstrong in paras. 57-75 of the SC Appeal Court decision, in my respectful opinion, in determining that Sattva is entitled to be paid its finder's fee in shares priced at $0.15 per share, the arbitrator reasonably construed the Agreement as a whole. Although Justice Armstrong conducted a correctness review of the arbitrator's decision, his reasons amply demonstrate the reasonableness of that decision. The following analysis is largely based upon his reasoning.

108 The question that the arbitrator had to decide was which date should be used to determine the price of the shares used to pay the finder's fee: the date specified in the Market Price definition in the Agreement or the date the finder's fee was to be paid?

109 The arbitrator concluded that the price determined by the Market Price definition prevailed, i.e. $0.15 per share. In his view, this conclusion followed from the words of the Agreement and was "clear and beyond argument" (para. 23). Apparently, because he considered this issue clear, he did not offer extensive reasons in support of his conclusion.

110 In *N.L.N.U.*, Abella J. cites Professor David Dyzenhaus to explain that, when conducting a reasonableness review, it is permissible for reviewing courts to supplement the reasons of the original decision-maker as part of the reasonableness analysis:

> ”Reasonable” means here that the reasons do in fact or in principle support the conclusion reached. That is, even if the reasons in fact given do not seem wholly adequate to support the decision, the court must first seek to supplement them before it seeks to subvert them. For if it is right that among the reasons for deference are the appointment of the tribunal and not the court as the front line adjudicator, the tribunal's proximity to the dispute, its expertise, etc, then it is also the case that its decision should be presumed to be correct even if its reasons are in some respects defective. [Emphasis added by Abella J.; para. 12.]
>
> (Quotation from D. Dyzenhaus, "The Politics of Deference: Judicial Review and Democracy", in M. Taggart, ed., *The Province of Administrative Law* (1997), 279, at p. 304.)

Accordingly, Justice Armstrong's explanation of the interaction between the Market Price definition and the "maximum amount" proviso can be considered a supplement to the arbitrator's reasons.

111 The two provisions at issue here are the Market Price definition and the "maximum amount" proviso:

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> **2. DEFINITIONS**
>
> **"Market Price"** for companies listed on the TSX Venture Exchange shall have the meaning as set out in the Corporate Finance Manual of the TSX Venture Exchange as calculated on close of business day before the issuance of the press release announcing the Acquisition. For companies listed on the TSX, Market Price means the average closing price of the Company's stock on a recognized exchange five trading days immediately preceding the issuance of the press release announcing the Acquisition.

And:

> **3. FINDER'S FEE**
>
> 3.1 ... the Company agrees that on the closing of an Acquisition introduced to Company by the Finder, the Company will pay the Finder a finder's fee (the "Finder's Fee") based on Consideration paid to the vendor equal to the maximum amount payable pursuant to the rules and policies of the TSX Venture Exchange. Such finder's fee is to be paid in shares of the Company based on Market Price or, at the option of the Finder, any combination of shares and cash, provided the amount does not exceed the maximum amount as set out in the Exchange Policy 5.1, Section 3.3 Finder's Fee Limitations.
>
> [Emphasis added.]

112 Section 3.1 entitles Sattva to be paid a finder's fee in shares based on the "Market Price". Section 2 of the Agreement states that Market Price for companies listed on the TSXV should be "calculated on close of business day before the issuance of the press release announcing the Acquisition". In this case, shares priced on the basis of the Market Price definition would be $0.15 per share. The words "provided the amount does not exceed the maximum amount as set out in the Exchange Policy 5.1, Section 3.3 Finder's Fee Limitations" in s. 3.1 of the Agreement constitute the "maximum amount" proviso. This proviso limits the amount of the finder's fee. The maximum finder's fee in this case is US$1.5 million (see s. 3.3 of the TSXV Policy 5.1 in Appendix II).

113 While the "maximum amount" proviso limits the amount of the finder's fee, it does not affect the Market Price definition. As Justice Armstrong explained, the Market Price definition acts to fix the date at which one medium of payment (US$) is transferred into another (shares):

> The medium for payment of the finder's fee is clearly established by the fee agreement. The market value of those shares at the time that the parties entered into the fee agreement was unknown. The respondent analogizes between payment of the $1.5 million US finder's fee in shares and a hypothetical agreement permitting payment of $1.5 million US in Canadian dollars. Both agreements would contemplate a fee paid in different currencies. The exchange rate of the US and Canadian dollar would be fixed to a particulate date, as is the value of the shares by way of the Market Price in the fee agreement. That exchange rate would determine the number of Canadian dollars paid in order to satisfy the $1.5 million US fee, as the Market Price does for the number of shares paid in relation to the fee. The Canadian dollar is the form of the fee payment, as are the shares. Whether the Canadian dollar increased or decreased in value after the date on which the exchange rate is based is irrelevant. The amount of the fee paid remains $1.5 million US, payable in the number of Canadian dollars (or shares) equal to the amount of the fee based on the value of that currency on the date that the value is determined.
>
> (SC Appeal Court decision, at para. 71)

114 Justice Armstrong explained that Creston's position requires the Market Price definition to be ignored and for the shares to be priced based on the valuation done in anticipation of a private placement.

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115 However, nothing in the Agreement expresses or implies that compliance with the "maximum amount" proviso should be reassessed at a date closer to the payment of the finder's fee. Nor is the basis for the new valuation, in this case a private placement, mentioned or implied in the Agreement. To accept Creston's interpretation would be to ignore the words of the Agreement which provide that the "finder's fee is to be paid in shares of the Company based on Market Price".

116 The arbitrator's decision that the shares should be priced according to the Market Price definition gives effect to both the Market Price definition and the "maximum amount" proviso. The arbitrator's interpretation of the Agreement, as explained by Justice Armstrong, achieves this goal by reconciling the Market Price definition and the "maximum amount" proviso in a manner that cannot be said to be unreasonable.

117 As Justice Armstrong explained, setting the share price in advance creates a risk that makes selecting payment in shares qualitatively different from choosing payment in cash. There is an inherent risk in accepting a fee paid in shares that is not present when accepting a fee paid in cash. A fee paid in cash has a specific predetermined value. By contrast, when a fee is paid in shares, the price of the shares (or mechanism to determine the price of the shares) is set in advance. However, the price of those shares on the market will change over time. The recipient of a fee paid in shares hopes the share price will rise resulting in shares with a market value greater than the value of the shares at the predetermined price. However, if the share price falls, the recipient will receive shares worth less than the value of the shares at the predetermined price. This risk is well known to those operating in the business sphere and both Creston and Sattva would have been aware of this as sophisticated business parties.

118 By accepting payment in shares, Sattva was accepting that it was subject to the volatility of the market. If Creston's share price had fallen, Sattva would still have been bound by the share price determined according to the Market Price definition resulting in it receiving a fee paid in shares with a market value of less than the maximum amount of US$1.5 million. It would make little sense to accept the risk of the share price decreasing without the possibility of benefitting from the share price increasing. As Justice Armstrong stated:

> It would be inconsistent with sound commercial principles to insulate the appellant from a rise in share prices that benefitted the respondent at the date that the fee became payable, when such a rise was foreseeable and ought to have been addressed by the appellant, just as it would be inconsistent with sound commercial principles, and the terms of the fee agreement, to increase the number of shares allocated to the respondent had their value decreased relative to the Market Price by the date that the fee became payable. Both parties accepted the possibility of a change in the value of the shares after the Market Price was determined when entering into the fee agreement.
>
> (SC Appeal Court decision, at para. 70)

119 For these reasons, the arbitrator did not ignore the "maximum amount" proviso. The arbitrator's reasoning, as explained by Justice Armstrong, meets the reasonableness threshold of justifiability, transparency and intelligibility (*Dunsmuir*, at para. 47).

***E. Appeal Courts Are Not Bound by Comments on the Merits of the Appeal Made by Leave Courts***

120 The CA Appeal Court held that it and the SC Appeal Court were bound by the findings made by the CA Leave Court regarding not simply the decision to grant leave to appeal, but also the merits of the appeal. In other words, it found that the SC

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Appeal Court erred in law by ignoring the findings of the CA Leave Court regarding the merits of the appeal.

121 The CA Appeal Court noted two specific findings regarding the merits of the appeal that it held were binding on it and the SC Appeal Court: (1) it would be anomalous if the Agreement allowed Sattva to receive US$1.5 million if it received its fee in cash, but allowed it to receive shares valued at approximately $8 million if Sattva received its fee in shares; and (2) that the arbitrator ignored this anomaly and did not address s. 3.1 of the Agreement:

> The [SC Appeal Court] judge found the arbitrator had expressly addressed the maximum amount payable under paragraph 3.1 of the Agreement and that he was correct.
>
> This finding is contrary to the remarks of Madam Justice Newbury in the earlier appeal that, if Sattva took its fee in shares valued at $0.15, it would receive a fee having a value at the time the fee became payable of over $8 million. If the fee were taken in cash, the amount payable would be $1.5 million US. Newbury J.A. specifically held that the arbitrator did not note this anomaly and did not address the meaning of paragraph 3.1 of the Agreement.
>
> The [SC Appeal Court] judge was bound to accept those findings. Similarly, absent a five-judge division in this appeal, we must also accept those findings. [paras. 42-44]

122 With respect, the CA Appeal Court erred in holding that the CA Leave Court's comments on the merits of the appeal were binding on it and on the SC Appeal Court. A court considering whether leave should be granted is not adjudicating the merits of the case (*Canadian Western Bank v. Alberta*, 2007 SCC 22, [2007] 2 S.C.R. 3 (S.C.C.), at para. 88). A leave court decides only whether the matter warrants granting leave, not whether the appeal will be successful (*Pacifica Mortgage Investment Corp. v. Laus Holdings Ltd.*, 2013 BCCA 95, 333 B.C.A.C. 310 (B.C. C.A.), at para. 27, leave to appeal refused, [2013] 3 S.C.R. viii (note) (S.C.C.)). This is true even where the determination of whether to grant leave involves, as in this case, a preliminary consideration of the question of law at issue. A grant of leave cannot bind or limit the powers of the court hearing the actual appeal (*Tamil Co-operative Homes Inc. v. Arulappah* (2000), 49 O.R. (3d) 566 (Ont. C.A.), at para. 32).

123 Creston concedes this point but argues that the CA Appeal Court's finding that it was bound by the CA Leave Court was inconsequential because the CA Appeal Court came to the same conclusion on the merits as the CA Leave Court based on separate and independent reasoning.

124 The fact that the CA Appeal Court provided its own reasoning as to why it came to the same conclusion as the CA Leave Court does not vitiate the error. Once the CA Appeal Court treated the CA Leave Court's reasons on the merits as binding, it could hardly have come to any other decision. As counsel for Sattva pointed out, treating the leave decision as binding would render an appeal futile.

**VI. Conclusion**

125 The CA Leave Court erred in granting leave to appeal in this case. In any event, the arbitrator's decision was reasonable. The appeal from the judgments of the Court of Appeal for British Columbia dated May 14, 2010 and August 7, 2012 is allowed with costs throughout and the arbitrator's award is reinstated.

*Appeals allowed.*

*Pourvois accueillis.*

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## Appendix I

*Relevant Provisions of the Sattva-Creston Finder's Fee Agreement*

(a) "Market Price" definition:

**2. DEFINITIONS**

**"Market Price"** for companies listed on the TSX Venture Exchange shall have the meaning as set out in the Corporate Finance Manual of the TSX Venture Exchange as calculated on close of business day before the issuance of the press release announcing the Acquisition. For companies listed on the TSX, Market Price means the average closing price of the Company's stock on a recognized exchange five trading days immediately preceding the issuance of the press release announcing the Acquisition.

(b) Finder's fee provision (which contains the "maximum amount" proviso):

**3. FINDER'S FEE**

3.1 ... the Company agrees that on the closing of an Acquisition introduced to Company by the Finder, the Company will pay the Finder a finder's fee (the "Finder's Fee") based on Consideration paid to the vendor equal to the maximum amount payable pursuant to the rules and policies of the TSX Venture Exchange. Such finder's fee is to be paid in shares of the Company based on Market Price or, at the option of the Finder, any combination of shares and cash, provided the amount does not exceed the maximum amount as set out in the Exchange Policy 5.1, Section 3.3 Finder's Fee Limitations.

## Appendix II

*Section 3.3 of TSX Venture Exchange Policy 5.1: Loans, Bonuses, Finder's Fees and Commissions*

**3.3 Finder's Fee Limitations**

The finder's fee limitations apply if the benefit to the Issuer is an asset purchase or sale, joint venture agreement, or if the benefit to the Issuer is not a specific financing. The consideration should be stated both in dollars and as a percentage of the value of the benefit received. Unless there are unusual circumstances, the finder's fee should not exceed the following percentages:

| Benefit | Finder's Fee |
|---|---|
| On the first $300,000 | Up to 10% |
| From $300,000 to $1,000,000 | Up to 7.5% |
| From $1,000,000 and over | Up to 5% |

As the dollar value of the benefit increases, the fee or commission, as a percentage of that dollar value should generally decrease.

## Appendix III

*Commercial Arbitration Act, R.S.B.C. 1996, c. 55 (as it read on January 12, 2007) (now the Arbitration Act)*

**Appeal to the court**
**31**

(1) A party to an arbitration may appeal to the court on any question of law arising out of the award if

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(a) all of the parties to the arbitration consent, or

(b) the court grants leave to appeal.

(2) In an application for leave under subsection (1) (b), the court may grant leave if it determines that

(a) the importance of the result of the arbitration to the parties justifies the intervention of the court and the determination of the point of law may prevent a miscarriage of justice,

(b) the point of law is of importance to some class or body of persons of which the applicant is a member, or

(c) the point of law is of general or public importance.

(3) If the court grants leave to appeal under this section, it may attach conditions to the order granting leave that it considers just.

(4) On an appeal to the court, the court may

(a) confirm, amend or set aside the award, or

(b) remit the award to the arbitrator together with the court's opinion on the question of law that was the subject of the appeal.

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

AND IN THE MATTER OF A PLAN OF COMPROMISE OR ARRANGEMENT OF NELSON EDUCATION LTD. AND NELSON EDUCATION HOLDINGS LTD. (collectively, the "**APPLICANTS**")

Court File No.: CV15-10961-CL

***ONTARIO***
**SUPERIOR COURT OF JUSTICE**
(COMMERCIAL LIST)

Proceedings commenced at **Toronto**

**BOOK OF AUTHORITIES OF THE ROYAL BANK OF CANADA (RETURNABLE ON AUGUST 13, 2015)**

**Thornton Grout Finnigan LLP**
Barristers & Solicitors
Suite 3200, TD West Tower
100 Wellington Street West
P.O. Box 329, Toronto-Dominion Centre
Toronto, ON M5K 1K7

**D.J. Miller** ( LSUC# 34393P)
djmiller@tgf.ca
Tel: (416) 304-0559

**Kyla E. M. Mahar** (LSUC# 44182G)
kmahar@tgf.ca
Tel: (416) 304-0594
Fax: (416) 304-1313

Lawyers for Royal Bank of Canada